TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY, PETITIONER,

vs.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED JUNE 7, 1938.

CERTIORARI GRANTED OCTOBER 10, 1938.

SUPREME COURT OF THE UNITED STATES

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., JUNE 14, 1938.

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[fol. 1] **IN COURT OF CLAIMS**

No. 43592

M. E. Blatt Company

v.

The United States

I. Petition—Filed July 12, 1937

To the Chief Justice and Judges of the Court of Claims:

Petitioner and plaintiff, M. E. Blatt Company, respectfully represents:

1. The plaintiff is a corporation organized and existing under the laws of the State of New Jersey and has its office and principal place of business at Atlantic City, New Jersey.

2. In 1932, in conformity with the requirements of the Revenue Act of 1932, the plaintiff made and filed with the Collector of Internal Revenue at Camden, New Jersey, a consolidated return of income for the fiscal year ended January 31, 1932, for itself and an affiliated corporation, Mebco Realty Holding Company. The said return showed a tax due on the consolidated net income amounting to $1,294.25 which was duly paid by the plaintiff to the Collector of Internal Revenue.

3. Thereafter, upon the audit of the return in the Bureau of Internal Revenue, certain changes were made, including the addition of $1,742.31 to the net income of Mebco Realty Holding Company, upon the findings of an internal revenue [fol. 2] agent and for reasons hereinafter stated, infra. All the said changes resulted in a deficiency tax of $1,133.84, which included $209.08 on account of the addition of the said $1,742.31 to the net income of Mebco Realty Holding Company. The said deficiency tax of $1,133.84, with interest amounting to $160.41, was duly paid by the plaintiff to the Collector of Internal Revenue on September 5, 1934.

4. The findings on which was based the addition of $1,742.31 to the net income of Mebco Realty Holding Company were as follows:

In 1927 the plaintiff, through its affiliate Mebco Realty Holding Company, acquired by purchase a theatre, store and apartment building known as the City Square property on Atlantic Avenue, Atlantic City, New Jersey, adjacent to the plaintiff's place of business, title to the City Square property being taken in the name of Mebco Realty Holding Company. Thereafter and until some time in 1929 the said property was leased to the Stanley Company of America, which operated a theatre, and to other tenants who occupied the stores and apartments. All the said leases expired during the early part of 1929 and were not renewed.

September 13 and October 3, 1930, Mebco Realty Holding Company, as owner and lessor, entered into agreements with Ventnor Realty & Leasing Company, as lessee, and M. B. Markland Company, as contractor, which provided for the making of alterations and improvements, in accordance with certain plans and specifications, at cost to the lessor, Mebco Realty Holding Company, not to exceed $65,000.00, and for the leasing of the property to Ventnor Realty & Leasing Company for the operation of a first-class picture theatre [fol. 3] for a term of ten years beginning upon the day the improvements stipulated in the lease were completed and ending ten years from the commencement of the lease but in no event later than December 31, 1940.

Thereafter the said alterations and improvements were completed, together with other improvements requested and ordered by the parties in interest, the total cost of all such alterations and improvements being $114,468.77, of which $73,794.47 was paid by the lessor, Mebco Realty Holding Company, and $40,674.30 was paid by the lessee, Ventnor Realty & Leasing Company, as follows:

Paid by Mebco Realty Holding Company:

Brick, steel, lumber, concrete, used in building	$45,068.73	
Heating and plumbing system	7,716.82	
Electrical work	8,699.84	
Ventilation system (partial)	3,514.61	
		$65,000.00
Building changes	661.86	
New store fronts (4)	8,132.61	
		8,794.47
		$73,794.47

Paid by Ventnor Realty & Leasing Company:		
Ventilating system (balance)	3,959.75	
Decorating, glazing, and architect's fees	11,313.14	
Chairs	9,167.24	
Booth	5,197.39	
Draperies	7,075.42	
Electric signs and marquee	3,961.36	
		40,674.30
		$114,468.77

[fol. 4] The said alterations and improvements were completed and the lessee went into possession under the terms of the lease, on or about February 1, 1931.

Thereafter, in the audit of the consolidated income tax return filed by the plaintiff and Mebco Realty Holding Company for the fiscal year ended January 31, 1932, it was determined by the internal revenue agent that the cost of the said improvements made by the lessee, to wit, $40,674.30, constituted taxable income to the lessor to the extent of the estimated salvage or depreciated value of such improvements at the end of the term of the lease, as follows:

	Total	Rate	Depreciated value at termination of lease
Ventilating system (balance), glazing, architect's fees, and other items	$14,326.12	3%	$10,028.29
Painting	760.80	10%	0
Other improvements	185.97	10%	0
Chairs	9,167.24	6-2/3%	3,055.75
Booth	5,197.39	10%	0
Draperies	7,075.42	6-2/3%	2,358.47
Electric signs and marquee	3,961.36	5%	1,980.63
	$40,674.30		$17,423.14

and that an aliquot part thereof, to wit, ten per cent or $1,742.31, should be added to the lessor's taxable income for each year of the lease. Revenue Act of 1932, sec. 22 (a); Regulations 77, Art. 63. Upon the basis of the said finding and determination the sum of $1,742.31 was added to the taxable income of Mebco Realty Holding Company for the fiscal year ended January 31, 1932, as stated in paragraph 3 supra.

[fol. 5] 5. The plaintiff avers that all the substantial improvements to the said property were those charged to the lessor, amounting to $73,794.47, as above set out; that the additional improvements which were charged to the lessee and for which the lessee paid $40,674.30, as above set out, including painting, decorating, glazing, installation of chairs, booths, draperies, and electric signs, and payment of architect's fees, were not improvements which added any substantial value to the property except for the purpose for which it was to be used by the lessee and so long as used by the lessee; that any value which the said improvements made by the lessee may have at the end of the term of ten years, or at any time to the lessor is uncertain and problematic and wholly impossible of ascertainment, by depreciation rates or otherwise, and at all events cannot be realized by the lessor until the sale or other disposition of the property; that no income, within the 16th Amendment to the Constitution of the United States, was realized by he plaintiff or by Mebco Realty Holding Company in the fiscal year ended January 31, 1932, by reason of the said improvements made by the lessee; and that the addition of $1,742.31 to the taxable income of Mebco Realty Holding Company for said fiscal year, for the reasons stated, was erroneous and improper.

6. Within two years after the payment of the deficiency tax assessed as stated in paragraph 3 supra, the plaintiff filed a claim for refund of $209.08, being so much of the deficiency tax as was based upon the addition of $1,742.31 to the taxable income of Mebco Realty Holding Company, as above stated. November 18, 1936, the said claim for refund was disallowed by the Commissioner of Internal Revenue.

[fol. 6] 7. No action or suit has been commenced or is pending in any court on account of the said claim, nor in Congress or in any of the executive department, except as stated above; no assignment or transfer of the whole or any part of the claim or of any interest therein has been made; the plaintiff has at all times borne true allegiance to the government of the United States and has not in any way voluntarily aided, abetted, or given encouragement to rebellion against the said government; and the plaintiff is justly entitled to the amount claimed, after allowing all just credits and set-offs.

Wherefore, the plaintiff prays judgment against the United States in the sum of Two Hundred Nine Dollars and Eight Cents ($209.08), with interest from 1932 as allowed by law.

M. E. Blatt Company, by M. E. Blatt, President.
Lawrence Cake, Attorney for Plaintiff.

Duly sworn to by M. E. Blatt. Jurat omitted in printing.

[fol. 7] II. General Traverse—Filed August 21, 1937

And now comes the Attorney General, on behalf of the United States, and answering the petition of the claimant herein, denies each and every allegation therein contained; and asks judgment that the petition be dismissed.

James W. Morris, Assistant Attorney General.

III. Argument and Submission of Case

On April 5, 1938, this case was argued and submitted on merits by Mr. Lawrence Cake, for plaintiff, and by Mr. Samuel E. Blackham, for defendant.

[fol. 8] IV. **Special Findings of Fact, Conclusion of Law and Opinion of the Court by Littleton, J.**—Filed May 31, 1938

Mr. Lawrence Cake for the plaintiff.

Mr. Samuel E. Blackham, with whom was Mr. Assistant Attorney General James W. Morris, for the defendant.

Mr. Robert N. Anderson and Mr. Fred K. Dyar were on the brief.

Plaintiff seeks to recover $211.61, additional income tax assessed and paid for its fiscal taxable year ending January 31, 1932, together with interest from September 5, 1934. This additional tax resulted from the inclusion in income of a lessor of real estate of an aliquot part of the depreciated cost or value of improvements made to such leased premises by the lessee.

The question presented is whether improvements made by a lessee, as required by the lease agreement, to the property which is the subject of the lease and which improvements become the property of the lessor, constitute income to the lessor at the time of completion of the improvements to the extent of the fair market value thereof.

Plaintiff contends that improvements made by the lessee cannot be held to constitute income to the lessor prior to sale or other disposition by him of the improvements made by the lessee or a sale of the property of which the improvements constitute a part.

[fol. 9] SPECIAL FINDINGS OF FACT

1. The plaintiff, a New Jersey corporation with office and principal place of business at Atlantic City, made and filed a consolidated return of income for the taxable year ended January 31, 1932, for itself and a subsidiary corporation, Mebco Realty Holding Company, all the stock of which was owned by the plaintiff. This return showed a tax of $3,-920.10, which was paid by the plaintiff.

2. Thereafter, upon the audit of the return, certain changes were made including the addition of $1,742.31 to the reported income of Mebco Realty Holding Company on account of certain improvements made to property owned by Mebco Realty Holding Company by the lessee of the property, which improvements were held by the Commissioner of Internal Revenue to constitute income to the lessor to the extent of the estimated depreciated value thereof at the termination of the lease. All the changes in the plaintiff's return resulted in a deficiency tax of $1,133.84, which was assessed against the plaintiff, and which, with interest amounting to $160.41, was paid by the plaintiff September 5, 1934.

3. The addition of $1,742.31 to the reported income of Mebco Realty Holding Company, as stated in finding 2, was based upon the following facts:

In 1927 Mebco Realty Holding Company (hereinafter referred to as the Realty Company) acquired by purchase certain improved real estate in Atlantic City, New Jersey, described as No. 1318 Atlantic Avenue.

September 13, 1930, the Realty Holding Co. leased this property to Ventnor Realty & Leasing Company, a New

Jersey corporation (hereinafter referred to as the Ventnor Company) for use as a moving picture theater, for a term of ten years, beginning upon the day certain improvements were completed by the landlord and ending ten years from the commencement of the lease but in no event later than December 31, 1940. With respect to the contemplated improvements to the property the lease provided:

5. It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make [fol. 10] and complete alterations to the entrance and theatre, which is to accommodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord.

October 3, 1930, the Realty Co., as owner, entered into a contract with M. B. Markland Company, as contractor, for the making of alterations and improvements as contemplated by the parties to the lease, in accordance with plans prepared by an architect employed by the parties upon the following terms and conditions, among others: that the owner (Mebco Realty Holding Company) would pay the actual cost of the alterations and improvements agreed upon by the parties and in accordance with the architect's plans, plus a contractor's profit of 10 per cent, provided that the total cost, including contractor's profit and architect's fee, would not exceed $65,000; and that "such additional work and materials as may be ordered by the Ventnor Realty & Leasing Company shall be paid for by said Ventnor Realty & Leasing Company." At the same time the Ventnor Company executed an agreement consenting to all the terms of the foregoing contract, as being made pursuant to the terms of the lease, and agreeing to pay for such work and labor in addition to work and labor covered by the contract, as it (the Ventnor Company), might order.

All the alterations and improvements were completed in January 1931, and the Ventnor Company, as lessee, took possession of the property February 1, 1931.

The total cost of all the alterations and improvements was $114,468.77 which was charged to the lessor and lessee, respectively, and paid for by them, as follows:

[fol. 11] Paid by the Realty Company, lessor:

Brick, steel, lumber, concrete	$45,068.73	
Heating and plumbing system	7,716.82	
Electrical work	8,699.84	
Ventilation system (partial)	3,514.61	
		$65,000.00
Building changes	661.86	
New store fronts (4)	8,132.61	
		8,794.47
		$73,794.47

Paid by the Ventnor Company, lessee:

Ventilating system (balance)	3,959.75	
Decorating, glazing, and architect's fee	11,313.14	
Chairs	9,167.24	
Booth	5,197.39	
Draperies	7,075.42	
Electric signs and marquee	3,961.36	
		40,674.30
		$114,468.77

The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was computed by the Commissioner and was agreed to by the plaintiff, as follows:

	Cost	Depreciated value at end of 10 years
Ventilating system	$3,959.75	$2,771.83
Glazing, architect's fee, and other items	10,366.37	7,256.46
Painting	760.80	0
Other improvements	185.97	0
Chairs	9,167.24	3,055.75
Booth	5,197.39	0
Draperies	7,075.42	2,358.47
Electric signs and marquee	3,961.36	1,980.63
	$40,674.30	$17,423.14

4. The additional tax paid by the plaintiff for 1932 as the result of the addition of $1,742.31 to the income of the Realty Company amounted to $211.61.

5. Thereafter plaintiff filed a timely claim for refund on the ground that the addition of $1,742.31 to the reported income of the Realty Company, as reflected in the plaintiff's [fol. 12] consolidated return for 1932, was incorrect. The claim was disallowed February 5, 1937.

Conclusion of Law

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that plaintiff is not entitled to recover, and its petition is dismissed.

Judgment is rendered against plaintiff for the cost of printing the record herein, the amount thereof to be entered by the clerk and collected by him according to law.

Opinion

Littleton, Judge, delivered the opinion of the court:

Plaintiff relies upon the decision of the Circuit Court of Appeals, 2nd Circuit, in Hewitt Realty Company v. Commissioner, 76 Fed. (2d) 880, in which the court held in substance that no taxable income is derived by a lessor from improvements made to leased buildings or from buildings constructed upon leased land by the lessee until such improvements are sold or disposed of by the lessor. In support of this holding, plaintiff insists that there can be no income, in a constitutional sense, unless there is a realization by the taxpayer either by severance from the source, as in the case of rent derived from property, or by conversion of both source and income into a different form, as in the case of a gain derived from the sale or exchange of property, and that mere appreciation in value, in whatever form arising, is not income until realized by sale or conversion of the property.

Since the adoption of the 16th Amendment, Congress has generally defined taxable gross income (section 22, Revenue Act of 1932) as including gains, profits, and income derived from dealings in property, whether real or personal, growing out of the ownership or use of, or interest in such property; also from rent or other gains or profits and income derived from any source whatever. The net income to be taxed is this gross income less the allowable deductions. It is clear that Congress intended in all of the revenue acts, except

[fol. 13] when otherwise specifically provided, to reach gains and profits of every description. Irwin v. Gavitt, 268 U. S. 162. And constitutional requirements as to the receipt of income are satisfied if the taxpayer has become the owner of property the value of which represents the gain. Poe v. Seaborn, 282 U. S. 101. Improvements to leased property made by a lessee, which become the property of the lessor at the time made, constitute compensation paid by the lessee as additional rental for the use of the leased premises. This compensation is a fixed, definite, and ascertainable amount under the contract. The cost of improvements less depreciation over the term of the lease is a fair measure of their present worth to the lessor as rental for the leased premises in addition to the stipulated money payments to be made by the lessee, and this amount may, we think, be properly regarded as a gain, profit, or income to the lessor under the Sixteenth Amendment and the statutory definition of taxable income. Such amount is not an indefinite element similar to natural appreciation in market value of property owned by a taxpayer or appreciation in value through capital improvements made by the owner of the property which need some form of measurement, such as a sale, to be rendered definitely known and ascertainable in amount. A lessor has the unrestricted ownership of the leased premises, although, as a result of the lease, he is deprived of the beneficial use of the leased premises and, therefore, of the beneficial use of the gains accruing to him through improvements constructed by the lessee, but we think it is clear that under the statute the gain, profit, or income is not divested of its character, as such, by the lease arrangement which may limit, for a time, its use or disposal by the taxpayer or which may entirely deprive the lessor for the period stated in the lease of the beneficial use of the gain. Lucas v. Earl, 281 U. S. 111; Lonsdale v. Commissioner, 32 Fed. (2d) 537; Cleveland Railway Company v. Commissioner, 36 Fed. (2d) 347; Standard Slag Company v. Commissioner, 63 Fed. (2d) 820; Commissioner v. Terre Haute Electric Co., Inc., 67 Fed. (2d) 697. The lessor is free to sell or otherwise dispose of the improvements subject to the lease. These views on the question presented are sup-[fol. 14] ported by the weight of authority upon the subject. Miller v. Gearin, 258 Fed. 225; United States v. Boston & Providence R. R. Corporation, 37 Fed. (2d) 670;

Crane v. Commissioner, 68 Fed. (2d) 640; Slack and Merwin, Exrs., v. Commissioner, 35 B. T. A. 271; Morphy v. Commissioner, 35 B. T. A. 289. The case of Hewitt Realty Co. v. Commissioner, supra, is distinguishable upon the facts. In that case the original term of the lease was for a period of 21 years and the improvements (a new building) constructed in 1931 by the lessee upon the leased premises had a useful life of 40 years. The Commissioner used the original 21-year term of the lease in computing the lessor's gain. But the lease contained a provision reserving to the lessee the right at the end of 21 years to renew the lease for three successive-running terms, or for a period of 63 years beyond the original term of 21 years. On this point the court held, and with this holding we agree, that effect should be given to the right of the lessee to continue the lease for a term beyond the useful life of the improvements. There was, therefore, no present increase in the net worth to the lessor and no existing or ascertainable gain to the taxpayer under the interpretations of the statute as set forth in Treasury regulations and decisions. In such a case a taxpayer, lessor, derives no profit or income unless the lease is terminated or until he sells the improvements.

Whether the gain or income to the lessor, through improvements made to the leased premises by the lessee, should be treated as taxable to the lessor in the year in which the improvements are completed or allocated and taxed annually over the term of the lease, or be treated as taxable in the year of expiration or termination of the lease, is a matter about which there might well be a difference of opinion. The regulations and decisions of the department charged with the administration and enforcement of the revenue laws should be sustained, unless they are contrary to the statute or exceed the authority conferred to make all needful rules and regulations for the necessary and proper enforcement of the provisions of the Revenue Acts.

Art. 63, Treasury Regs. 77, promulgated under the Revenue Act of 1932, provides, so far as material here, as follows:

[fol. 15] Improvements by lessees.—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the

lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives no income by reason thereof, and, just as when the lessor comes into possession or control of the property upon the expiration of the lease, the basis for determining gain or loss to the lessor from the subsequent sale or other disposition of the buildings or improvements and for depreciation in respect of such property is the amount previously reported as income by the lessor because of the erection of the buildings or improvements, except that if the buildings or improvements were acquired prior to March 1, 1913, the basis shall be their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See articles 130 and 204.)
[fol. 16] In all cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of

the property prior to the time originally fixed for the expiration of the lease, the lessor derives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise.

This regulation substantially conforms to all regulations and decisions of the Treasury Department since the adoption and promulgation in 1920 of Art. 48, Regs. 45, under the Revenue Act of 1918. Thus, for more than eighteen years, income derived by a lessor through improvements made to the leased premises by the lessee have been treated as taxable to the lessor to the extent of the present value thereof, either in the year in which the improvements were completed or proportionately in each year over the term of the lease. Since the adoption and promulgation of this regulation, which was applied and followed by the Commissioner of Internal Revenue in determining the income and the tax involved in this proceeding, the Congress has enacted seven general revenue statutes without in any way disturbing the regulations and decisions of the Treasury Department on this question. From this it seems clear that the Congress has given its approval to the interpretation of the statutes by the administrative branch of the Government charged with their administration and enforcement. National Lead Co. v. United States, 52 U. S. 140; Duffy v. Central Railroad Co. of New Jersey, 268 U. S. 55, 57; Brewster v. Gage, 280 U. S. 327, 337; United States v. [fol. 17] Farrar, 281 U. S. 624; Universal Battery Co. v. United States, 281 U. S. 580; Poe v. Seaborn, supra; McCaughn v. Hershey Chocolate Co., 283 U. S. 488, 492; Old Colony Railroad Co. v. Commissioner, 284 U. S. 552, 557; Massachusetts Mutual Life Insurance Co. v. United States, 288 U. S. 269; Old Mission Portland Cement Co. v. Helver-

ing, 293 U. S. 289; Hartley v. Commissioner, 295 U. S. 216, 220; and Williams v. Burnet, 59 Fed. (2d) 357.

Plaintiff is not entitled to recover and the petition is dismissed. It is so ordered.

Whaley, Judge; Williams, Judge; Green, Judge; and Booth, Chief Justice, concur.

[fol. 18] V. JUDGMENT

At a Court of Claims held at the City of Washington on the 31st day of May, A. D., 1938, judgment was ordered to be entered as follows:

Upon the special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that plaintiff is not entitled to recover.

It is Therefore Adjudged and Ordered that the plaintiff's petition be and the same is hereby dismissed.

[fol. 19] Clerk's certificate to foregoing transcript omitted in printing.

Endorsed on cover: File No. 42583. Court of Claims. Term No. 98. M. E. Blatt Company, petitioner, vs. The United States. Petition for a writ of certiorari and exhibit thereto. Filed June 7, 1938. Term No. 98, O. T., 1938.

[fol. 20] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 10, 1938

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY,
Petitioner,

vs.

THE UNITED STATES.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS AND BRIEF IN SUPPORT THEREOF.

LAWRENCE CAKE,
Counsel for Petitioner.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY,

Petitioner,

vs.

THE UNITED STATES.

PETITION FOR CERTIORARI TO THE COURT OF CLAIMS.

The petition of M. E. Blatt Company respectfully represents:

Summary Statement.

Petitioner sued in the Court of Claims to recover the amount of an income tax deficiency assessed and paid for its fiscal and taxable year ended January 31, 1932.

The additional tax in dispute resulted from the inclusion in petitioner's gross income for the taxable year of an item of $1,742.31, determined as follows:

Shortly before the beginning of the taxable year, petitioner leased certain real estate to Ventnor Realty & Leasing Company, for a term of ten years, for a moving picture theatre. As a part of the agreement the lessor undertook

to make certain alterations and improvements, and the lessee undertook to install moving picture and talking apparatus, theatre seats, and other fixtures, furniture and equipment necessary for the operation of a theatre. The lease expressly provided that all such fixtures, furniture and equipment "shall at the expiration or other sooner determination of this lease become the property of the landlord." In accordance with the agreement of the parties, the improvements were made, at a cost of $114,468.77 of which the lessee paid $40,674.30, as set out in the findings of fact. Upon the audit of petitioner's income tax return for the taxable year in question, the Commissioner determined that the depreciated value—at the end of the term of the lease—of the improvements for which the lessee had paid $40,674.30, would be $17,423.14, and that the latter amount should be spread over the term of the lease and an aliquot part thereof, i.e. one-tenth or $1,742.31, treated as income to the lessor for each year of the term, beginning with the taxable year ended January 31, 1932.

The question presented is whether improvements so made by a lessee, as required by the lease agreement, to the property which is the subject of the lease, which improvements become the property of the lessor at the expiration or other sooner determination of the lease, constitute income to the lessor at the time of completion of the improvements to the extent of the fair market value thereof.

The Commissioner's action, and the judgment of the court below, are supported by the Commissioner's regulations. Article 63 of Regulations 77 promulgated under the Revenue Act of 1932.

The petitioner contends: 1) that the question presented is not one of statutory construction, as intimated in the opinion of the court below, but is whether a certain appreciation or accession of value to property owned by petitioner is income or gain, in a constitutional sense, at the

time it occurs; and 2) that the improvements in question made by its lessee cannot be treated as income to petitioner until the sale or other disposition of the property of which the improvements are a part, because there is no income, in a constitutional sense, until there is a realization thereof by the taxpayer, either by severance from the source or by conversion of both source and income into a different form.

On the general issue stated—the validity of the regulations which treat as income to the lessor the value of improvements made by a lessee, the Treasury has been directly sustained by the Board of Tax Appeals in

Hewitt Realty Co., 29 B. T. A. 1205;
Emma C. Morphy, 35 B. T. A. 289;
Julia Willms Sloan, 36 B. T. A. 370.

The petitioner, on the other hand, is supported by the 2nd Circuit Court of Appeals, reversing the Board of Tax Appeals, in

Hewitt Realty Co. v. *Commissioner*, 76 F. (2d) 880;

and by the district courts for the districts of Maryland, Eastern Pennsylvania, and Connecticut, in

Hilgenberg v. *United States*, 21 Fed. Supp. 453;
Staples v. *United States*, 21 Fed. Supp. 737;
English v. *Bitgood*, 21 Fed. Supp. 641.

The Court of Claims in the instant case distinguishes the *Hewitt* case on the facts, and does not mention the several district court cases cited, although District Judge Coleman in the *Hilgenberg* case and District Judge Maris in the *Staples* case both filed lengthy opinions fully discussing the question.

Examination of the opinion in the *Hewitt* case will show that although the case might have been decided on narrower ground (in that the lessee there had an option to renew the lease) in fact the decision of the court went broadly on the

ground that the lessor could not be charged with the value of the improvements—as income—prior to sale or other disposition of the property, and that the Commissioner's regulations which required such treatment were invalid.

The decision in the *Hewitt* case has become a precedent and has been expressly followed in the three district court decisions cited.

In the opinions in all the cases cited, namely,

Hewitt Realty Co. v. *Commissioner*, 76 F. (2d) 880;
Hilgenberg v. *United States*, 21 Fed. Supp. 453;
Staples v. *United States*, 21 Fed. Supp. 737;
English v. *Bitgood*, 21 Fed. Supp. 641;

the question is fully discussed and the conclusion reached that the regulations in question are invalid.

The decision of the Court of Claims in the instant case is in irreconcilable conflict.

Reasons Relied on for Allowance of Certiorari.

The case involves an important question of Federal income tax law on which there is a conflict between the Court of Claims, on the one hand, and the Second Circuit Court of Appeals and district judges in the districts of Maryland, Eastern Pennsylvania, and Connecticut, on the other hand.

WHEREFORE your petitioner respectfully prays that a writ of certiorari issue out of and under the seal of this Court, directed to the Court of Claims, commanding that court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered and titled on its docket, No. 43592, M. E. Blatt Company *vs.* The United States.

M. E. BLATT COMPANY,
By LAWRENCE CAKE,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

Opinion of Court Below.

The opinion of the Court of Claims is in the record at pp. 9-14.

Jurisdiction.

Certiorari is sought under Section 3 (b) of the Act of February 13, 1925, c. 229, 43 Stats. 939; U. S. Code, Title 28, Section 288.

Final judgment was entered in the Court of Claims on May 31, 1938.

Statement of Case and Outline of Argument.

The facts are sufficiently stated in the petition for certiorari.

The question presented is whether improvements made by a lessee, as required by the lease agreement, to the property which is the subject of the lease, which improvements become the property of the lessor at the expiration or other sooner determination of the lease, constitute income to the lessor at the time of completion of the improvements to the extent of the fair market value thereof.

The Treasury takes the position that such improvements constitute income to the lessor to the extent of the estimated depreciated value thereof at the termination of the lease and that an aliquot part of such estimated value is chargeable to the lessor as income for each year of the term. Article 63 of Regulations 77 under the Revenue Act of 1932.

Origin of Present Regulations.

The first regulations dealing with the question of gain derived by a lessor from the construction or addition of improvements to leased property were Regulations 33 under

the Revenue Act of 1916, based on T. D. 2442, dated February 16, 1917, to the effect that "when improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation during the lease term is gain or profit to the lessor *at the end of the lease term* and is to be accounted for as income at that time."

In 1919, in *Miller* v. *Gearin*, 258 Fed. 225, this regulation was expressly disapproved by the Ninth Circuit Court of Appeals. In that case the property in question had been leased by the owner in 1907 pursuant to an agreement whereby the lessee erected a building. On the lessee's default in 1916 the owner took back the property. The Treasury taxed the owner on the increased value of his property as income realized in 1916. The court said:

> "The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income. It was not a gain, but was a loss. Assuming that the building was income derived from the use of the property, we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value. At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years. The lease provided that the ownership of all buildings or improvements put upon the premises was to vest in the lessor immediately upon the construction of the same, subject to the provisions of the lease. * * *"

In 1920, in *Cryan* v. *Wardell*, 263 Fed. 248, the District Court for the Northern District of California held to the same effect, following *Miller* v. *Gearin*. Certiorari to review the decision in *Miller* v. *Gearin* was sought by the Treasury but was denied, 250 U. S. 667.

Thereupon the Treasury changed the regulations to provide that the gain or income to the lessor resulting from the

making of improvements by a lessee would be treated as derived by the lessor "at the time when such buildings or improvements are completed." T. D. 3062, 3 Cum. Bull. 109, and Regulations 45 (1920 edition), Article 48, under the Revenue Act of 1918.

Again, in 1922, the regulations were amended to provide for the alternative treatment whereby the estimated depreciated value of the improvements might be spread over the life of the lease and an aliquot part thereof reported as income for each year of the lease. Regulations 62, Article 48, under the Revenue Act of 1921. Since then there has been no substantial change in the regulations.

The Decision in Miller v. *Gearin.*

Miller v. *Gearin* has been assumed to be authority for the proposition that a lessor may be taxed on the value of improvements added to real estate by the lessee thereof, *as income realized by the lessor at the time the improvements are added. United States* v. *Boston & Providence R. R. Co.*, 37 F. (2d) 670; *Crane* v. *Commissioner*, 68 F. (2d) 640. See also the decisions of the Board of Tax Appeals in *Slack*, 35 B. T. A. 271; *Morphy*, 35 B. T. A. 289, and *Sloan*, 36 B. T. A. 370.

That that assumption has been a mistaken one is apparent from a consideration of the facts in that case and the opinion of the court on the narrow issue involved. In effect *Miller* v. *Gearin* has been a very misleading case. In the *Hewitt* case, the *Hilgenberg* case and the *Staples* case, cited heretofore, the opinions particularly discuss and point out the misconception by the Treasury and the Board of Tax Appeals of the decision in *Miller* v. *Gearin*. On this point in the *Hilgenberg* case the court said:

> "The theory underlying the present attitude of the Commissioner and all of the decisions of the Board of Tax Appeals appears to be founded on the misconcep-

tion that since the value of the improvements is not income at the time the lease is terminated, it must of necessity be income when they are completed. This, of course, is a *non-sequitur*, because it need not be income at either time. * * * In so far as the decision in the *Miller* case, or in any other case referred to, is to be considered as a holding to this effect, we must disagree with such holding, because we believe that the conclusion and reasoning upon which such conclusion is based, in the *Hewitt Realty Company* case, *supra*, are more sound."

It may be noted also that in the *Morphy* case, 35 B. T. A. 289, three members of the Board dissented, as follows:

"ARUNDELL, *dissenting:*

It seems to me that the decision of the Second Circuit in the *Hewitt Realty* case, 76 F. (2d) 880, gives a sound solution to the question here involved. The substance of the holding in that case is that the erection of a building by a lessee does not result in realization of income to the lessor; the realization of income, if any, occurs when the lessor sells. This view, as stated by Judge Learned Hand, author of the majority opinion, 'answers every fiscal necessity far more directly and simply than any other formula.'

"The lease in the instant case was for a period of over thirty years. Under the view expressed in the Commissioner's regulations and approved by the majority opinion, it is necessary to look into the future to the time when the lease terminates and determine the value of the building after taking into account the ravages of time. In many cases of long-term leases the original term extends beyond the useful life of the improvements. Some of them involve definite provisions for renewal. There are always the possibilities of termination prior to the expiration of the agreed term, and accelerated depreciation and obsolescence resulting from causes unforeseeable when the lease is executed. These are factors that complicate any attempted appli-

cation of the Commissioner's regulations. But what is more serious they show the impossibility of determining with any fair certainty the amount to be treated under the regulations as realized income. A promise to turn over possession of a building many years hence, and subject to the many contingencies necessarily involved in any transaction extending over a period of years, does not seem to be in any proper sense the present equivalent of cash. Cf. *Burnet* v. *Logan*, 283 U. S. 404. The difficulty of determining as a matter of fact the value of improvements is recognized in both opinions filed in the *Hewitt* case. The majority opinion obviates the difficulty and offers a sound solutio . It treats as income the full amount eventually realized when it is actually realized. Anything short of this does not meet the test of realized income with which the taxing act is concerned. For these reasons, I think we should adopt the principle of the *Hewitt Realty* case and decline to follow the earlier cases that hold otherwise.

"Sternhagen and Tyson agree with this dissent."

The Lease in the Instant Case Expressly Stipulated That the Improvements Added by the Lessee Would Become the Property of the Lessor at the Expiration or Sooner Determination of the Lease.

This is expressly found in paragraph 3 of the special findings of fact, R. 6-8.

Yet the court below states in its opinion, as its conclusion on the principal issue, that "improvements to leased property made by a lessee, which become the property of the lessor at the time made, constitu compensation paid by the lessee as additional rental for the use of the leased premises."

The Improvements Made by the Lessee in the Instant Case Cannot Rightly Be Treated as Income to Petitioner Because There Was No Realization in the Taxable Year of Taxable Gain.

This is the fundamental question involved in the case. Petitioner submits, with respect for the decision of the court below, that the improvements in the instant case cannot be treated as income for the taxable year in question, unless the rule heretofore established by *Eisner* v. *Macomber*, 252 U. S. 189, and other cases, that to constitute taxable gain or income, in a constitutional sense, there must be a realization, either by severance from the source or by conversion of both source and gain into a different form, is to be disregarded or overruled.

It is to be noted that the improvements in the instant case, made by the tenant, were that part of the ventilating system charged to the tenant, glazing, architect's fee and other items, chairs, draperies, electric signs and marquee, all of which were the fixtures, furniture and equipment necessary for the operation of a theatre which the tenant agreed to install, and which, it was agreed, would become the property of the landlord at the expiration or other sooner determination of the lease.

It is difficult to understand how it can be contended, with any sense of reality, that the landlord realized any income upon the making of these improvements or at any time during the taxable year in question. The practical difficulty in the situation becomes more apparent, moreover, when consideration is given to the fact that the taxpayer must pay the tax on this income for each year of the lease, from 1932 to 1940, and to the provisions of recent and existing revenue acts, applicable for the years 1936 and 1937 and to some extent for 1938, which impose penalty taxes on the undis-

tributed income of corporations. It is a fair question to ask how the taxpayer in the instant case is to distribute this so-called income, chargeable to it for each taxable year from 1932 to 1940, so as to avoid the penalty taxes on undistributed income?

Respectfully submitted,

LAWRENCE CAKE,
Counsel for Petitioner.

FILE COPY

IN THE

Supreme Court of the United States

October Term, 1938

No. 98

M. E. Blatt Company, *Petitioner*,

v.

The United States.

On Writ of Certiorari to the Court of Claims.

BRIEF FOR PETITIONER.

Lawrence Cake,
Counsel for Petitioner.

Press of Byron S. Adams, Washington, D. C.

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OPINION BELOW.

The opinion of the Court of Claims (R. 9-14) is reported in 23 Fed. Supp. 461.

JURISDICTION.

Final judgment was entered in the Court of Claims on May 31, 1938 (R. 14). The petition for certiorari was filed on June 7, 1938 (R. 14) under Section 3 (b) of the Act of February 13, 1925, 43 Stat. 939, and was granted on October 10, 1938.

STATEMENT OF THE CASE.

1. Question Presented.

The question presented is whether improvements made by a lessee of real estate, which become the property of the lessor at the expiration or other sooner determination of the lease, constitute income to the lessor, either (1) to the extent of the fair market value thereof at the time of completion of the improvements, subject to the lease; or (2) to the extent of an aliquot part of the estimated depreciated value thereof at the expiration of the lease, applied to each year of the lease.

2. The Facts of the Case.

The additional tax in dispute, recovery of which is sought by petitioner, is for petitioner's fiscal and taxable year ended January 31, 1932, and results from the inclusion in gross income for that year of an item of $1,742.31 determined as follows:

Shortly before the beginning of the taxable year, petitioner leased certain real estate to Ventnor Realty & Leasing Company for a term of ten years, for a moving picture theatre. As a part of the agreement the lessor undertook to make certain alterations and improvements, and the lessee undertook to install moving picture and talking apparatus, theatre seats, and other fixtures, furniture and equipment necessary for the operation of a theatre. The lease expressly provided that all such fixtures, furniture and equipment "shall at the expiration or other sooner determination of this lease become the property of the landlord." (R. 6-7.)

In accordance with the agreement of the parties, the improvements were made, at a cost of $114,468.77 of which the lessee paid $40,674.30, as set out in the findings of fact (R. 8).

Upon the audit of petitioner's income tax return for the taxable year in question, the Commissioner of Internal Revenue determined that the depreciated value—at the end of the term of the lease—of the improvements for which the lessee had paid $40,674.30, would be $17,423.14, and that the latter amount should be spread over the term of the lease and an aliquot part thereof, *i. e.* one-tenth or $1,742.31, treated as income to the lessor for each year of the term, beginning with the taxable year ended January 31, 1932 (R. 6, 8).

The inclusion of $1,742.31, as stated, in petitioner's gross income for the taxable year in question, resulted in an additional tax of $211.61 which was duly paid (R. 8). Thereafter, a timely claim for refund was filed and was disallowed (R. 9) and this suit was commenced in the Court of Claims (R. 1).

3. Statutes and Regulations Involved.

Section 22 of the Revenue Act of 1932, c. 209, 47 Stat. 169:

> "(a) General definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

> "Art. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

* * * * * * * * *[1]

4. History of the Regulations.

The general question here involved, whether the value of improvements made by a lessee may be treated as income to the lessor prior to sale or other disposition of the property, is one which has caused difficulty for many years and has been the subject of considerable discussion[2] and some difference of opinion in the courts.

None of the revenue acts, from 1913 to 1938, contains any specific authority for the regulations which provide for the inclusion in gross income of such supposed gains. The regulations rest solely on the general definition of gross income, in every revenue act, as including "gains or profits and income derived from any source whatever."

The first regulations dealing with this question were Regulations 33, under the 1916 Act, based on T. D. 2442, dated February 6, 1917, to the effect that "when improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation during the

[1] The remainder of Art. 63 of Regulations 77 deals with cases where the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease.

[2] The Tax Magazine, October 1938, p. 577; 20 Minnesota Law Review, 320; 30 Illinois Law Review, 392; 47 Harvard Law Review, 1268; 51 Harvard Law Review, 1113; 98 American Law Reports, 1207; Paul & Mertens, *Law of Federal Income Taxation,* Vol. 1, sec. 10.12, and 1937 Supplement; Roswell Magill, *Taxable Income,* pp. 20, 103, 205.

lease term is gain or profit to the lessor *at the end of the lease term* and is to be accounted for as income at that time."

In 1919, in *Miller* v. *Gearin*, 258 Fed. 225, this regulation was held invalid by the 9th Circuit Court of Appeals. In that case the property had been leased by the owner in 1907 pursuant to an agreement whereby the lessee erected a building. On the lessee's default in 1916 the owner took back the property. The Treasury taxed the owner on the increased value of his property, as income realized in 1916. The Court said:

> "The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income. It was not a gain, but was a loss. Assuming that the building was income derived from the use of the property, we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value. At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years. The lease provided that the ownership of all buildings or improvements put upon the premises was to vest in the lessor immediately upon the construction of the same, subject to the provisions of the lease."

Certiorari to review *Miller* v. *Gearin* was sought by the Treasury but was denied, 250 U. S. 667.

Thereupon, the Treasury changed the regulations to provide that the gain or income to the lessor resulting from the making of improvements by a lessee would be treated as derived by the lessor "at the time when such buildings or improvements are completed." T. D. 3062, 3 Cum. Bull. 109. This change was incorporated in Regulations 45 (1920 edition), under the 1918 Act, as follows:

> "When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not

> subject to removal by the lessee, the lessor receives income at the time such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease."

Again, in 1922, the regulations were amended to provide for the alternative treatment whereby the estimated depreciated value of the improvements might be spread over the life of the lease and an aliquot part thereof reported as income for each year of the lease. Regulations 62, Article 48, under the 1921 Act.

Thereafter, until the regulations promulgated under the 1934 Act, there was no substantial change. Article 63 of Regulations 77, under the 1932 Act, here involved, is quoted above at page 3.

Article 22 (a)-13 of Regulations 86, under the 1934 Act, for the first time eliminated the words "in pursuance of an agreement with the lessor" contained in the prior regulations, thus making it immaterial whether the improvements were optional or required.

5. Decisions of the Courts.

The earliest decision on this question, *Miller* v. *Gearin*, 258 Fed. 225, is mentioned above. To the same effect is *Cryan* v. *Wardell*, 263 Fed. 248, in the District Court for the Northern District of California.

Other cases which indirectly or by way of dictum lend support to the Treasury regulations are *United States* v. *Boston & Providence R. R. Corp.*, 37 Fed. (2d) 670, and *Crane* v. *Commissioner*, 68 Fed. (2d) 640, both in the First Circuit Court of Appeals.[3]

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[3] In *Kentucky Block Coal Co.* v. *Lucas*, 4 Fed. Supp. 266, the District Court for the Western District of Kentucky held that the value of repairs and additions made by a lessee and which became a part of the lessor's realty when made, was taxable income to the lessor in the year in which made, but the court did not refer to any of the regulations or to any other decisions.

Cases in which the regulations have been directly upheld are *Campbell* v. *United States*, 384 C. C. H. 9408, in the District Court for the Territory of Hawaii, and the instant case now under review.

In the following cases, on the other hand, the regulations have been held to be invalid, in that they attempt to tax as income that which is not realized gain or income in a constitutional sense: *Hewitt Realty Co.* v. *Commissioner*, 76 Fed. (2d) 880, in the 2nd Circuit Court of Appeals; *Hilgenberg* v. *United States*, 21 Fed. Supp. 453, in the District Court for the District of Maryland; *Staples* v. *United States*, 21 Fed. Supp. 737, in the District Court for the Eastern District of Pennsylvania; *English* v. *Bitgood*, 21 Fed. Supp. 641, in the District Court for the District of Connecticut; *Dominick* v. *United States*, 384 C. C. H. 9418, in the District Court for the Southern District of New York; and *Fifteenth St. Investment Co.* v. *Nicholas*, 23 Fed. Supp. 863, in the District Court for the District of Colorado.

SPECIFICATION OF ERRORS.

The court below erred in holding, on the facts found, that the item of $1,742.31 in question constituted "income" to petitioner for the taxable year ended January 31, 1932, and in denying to petitioner a judgment for the recovery of the additional tax paid on account thereof.

ARGUMENT.

I. When improvements are made by a lessee, as in the instant case, there is no realization of gain by the lessor at the time the improvements are completed.

The Treasury regulations, and the action of the Commissioner in the instant case, are founded on the assumption that there is a *realization* of gain by the lessor *at the time the improvements are completed.* The whole case rests on that assumption. If there is no realization of gain by the lessor at the time the improvements are completed, there is

no "income" in the sense of the Sixteenth Amendment or in the sense of the statute.

It is settled and needs no argument that the Commissioner cannot by regulations make income of that which is not income in the constitutional sense. Nor can any long continued administrative interpretation, or the enactment of subsequent revenue acts by Congress impliedly approving such administrative interpretation, accomplish the same result. *Manhattan General Equipment Co.* v. *Commissioner,* 297 U. S. 129; *Koshland* v. *Helvering,* 298 U. S. 441.

The question here, however, does not go to the constitutionality of the statute. The statute does not specifically tax as income the "gain" which the Commissioner has taxed to petitioner in the instant case. The statute taxes "gains or profits and income derived from any source whatever." If the Commissioner's regulations on this question go too far, it follows that he has misconstrued the statute.

On what theory, then, does the Government contend that when improvements are made by a lessee there is a realization of gain by the lessor at the time the improvements are completed?

It is, as we understand it, the theory that upon the completion of the improvements there is an immediate accession of value to the lessor's property which is the equivalent of cash, in that (1) it can be measured by depreciation over the life of the lease, and (2) it can be converted into cash by selling the property subject to the lease. This theory is stated by the court below (R. 10) as follows:

> "Improvements to leased property made by a lessee, which become the property of the lessor at the time made, constitute compensation paid by the lessee as additional rental for the use of the leased premises. This compensation is a fixed, definite, and ascertainable amount under the contract. The cost of improvements less depreciation over the term of the lease is a fair measure of their present worth to the lessor as rental for the leased premises in addition to the stipulated money payments to be made by the lessee, and

this amount may, we think, be properly regarded as a gain, profit, or income to the lessor under the Sixteenth Amendment and the statutory definition of taxable income. Such amount is not an indefinite element similar to natural appreciation in market value of property owned by a taxpayer or appreciation in value through capital improvements made by the owner of the property which need some form of measurement, such as a sale, to be rendered definitely known and ascertainable in amount. A lessor has the unrestricted ownership of the leased premises, although, as a result of the lease, he is deprived of the beneficial use of the leased premises, and, therefore, of the beneficial use of the gains accruing to him through improvements constructed by the lessee, but we think it is clear that under the statute the gain, profit, or income is not divested of its character, as such, by the lease arrangement which may limit, for a time, its use or disposal by the taxpayer or which may entirely deprive the lessor for the period stated in the lease of the beneficial use of the gain. * * * The lessor is free to sell or otherwise dispose of the improvements subject to the lease."

A. The Theory on Which the Decision of the Court Below is Based is Fundamentally Unsound for Several Reasons.

1. *It ignores the fact that in the instant case, and in other similar cases caught in the net of the regulations, the supposed gain to the lessor is in no sense additional rental for the use of the premises.*

The provision of the lease in the instant case bearing on this question is quoted in the findings of fact (R. 7) as follows:

"5. It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make and complete alterations to the entrance and theatre, which is to accomodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties

> hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord."

Thus, the tenant agreed to paint and decorate (provided the landlord would pay $1,500 of the cost) and to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre. That was all. The tenant was not required to spend any certain amount. The amount was left entirely to his discretion and self-interest. He had a lease for ten years and presumably would spend as much on improvements as would fit the premises for his purpose, but he was not required to spend any amount whatever *for the benefit of the lessor*. So far as the lease went, his expenditures might well be limited to improvements which would have a life not exceeding the term of the lease. If he spent more and the improvements he made were of such a character as would carry over some residual value beyond the term of the lease, any such excess value would be a gift to the lessor. At all events it was not required by the terms of the lease.

The common definition of rent or rental is an agreed fixed payment for the use of property. It need not necessarily be payable in money but it must be agreed upon and it must be fixed in amount or quantity.

In *Duffy* v. *Central Railroad Company of New Jersey*, 268 U. S. 55, 63, an income tax case involving among other questions whether expenditures made by a long-term lessee for additions and betterments, as required by the terms of

the lease, could be treated as "additional rentals" for the use of the property, this court said:

> "The term 'rentals', since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as implying a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property. *Dodge* v. *Hogan*, 19 R. I. 4, 11; 2 Washburn, Real Property (6th ed.) 1187; and in that sense it does not include payments, uncertain both as to amount and time, made for the cost of improvements or even for taxes."

It seems clear, therefore, that whatever else it may be called, any future residual value in the improvements in question in the instant case, estimated as at the end of the term of the lease, cannot properly be regarded as additional rental to the landlord.

2. *It ignores the fundamental rule of income taxation laid down in Eisner* v. *Macomber, that to constitute taxable gain or income there must be a realization, either by severance from the source or by conversion of both source and gain into a different form, and that unrealized appreciation in value is not taxable as income.*

The general rule laid down in *Eisner* v. *Macomber*, 252 U. S. 189, has been established for nearly two decades. The reasoning on which the rule is based is clearly stated in the opinion, at page 207, where the court, after quoting the definition of income given in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415, and *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185,[4] said:

> "The Government, although basing its argument on the definition as quoted, placed chief emphasis upon the word 'gain', which was extended to include a variety of meanings; while the significance of the next

[4] "Income may be defined as the gain derived from capital, from labor, or from both combined."

three words was either overlooked or misconceived. '*Derived - from - capital*'; - 'the *gain - derived - from - capital*' etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being '*derived*', that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." (Italics as in Opinion)

The requirement of realization, thus laid down in *Eisner* v. *Macomber,* is still a fundamental rule of income taxation. As recently as 1936, in *United States* v. *Safety Car Heating & Lighting Co.,* 297 U. S. 88, 99, this court has said:

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition."

Compare also *Koshland* v. *Helvering,* 298 U. S. 441; *North American Oil Consolidated* v. *Burnet,* 286 U. S. 417; *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244; *Burnet* v. *Logan,* 283 U. S. 404.

What bearing has this requirement of realization on the instant case, and has the court below taken it sufficiently into consideration?

Here the petitioner is the owner of property which it has leased to another for ten years. The lessee of the property has added improvements which the Commissioner has found will have a residual value of $17,423.14 at the end of the term of the lease. The value of petitioner's property, therefore, has been increased and a part of that increased value will presumably still be in the property when it reverts to petitioner upon the termination of the lease. Has petitioner realized any immediate gain by virtue of all this? Certainly there has been nothing "severed" from the property (petitioner's capital) or "received or drawn" by petitioner for its "separate use, benefit and disposal." There

has been no gain or profit in the sense of "something of exchangeable value proceeding from the property." Petitioner has no control over the property, or the improvements, so long as the lease runs. Even when the lease ends, petitioner will have only the possession of real estate bearing improvements which fit it for use as a theatre.

The court below suggests, however, that petitioner has at all times a right to sell the property subject to the lease, and so immediately realize the cash value of the improvements to the extent that they will have value beyond the term of the lease. This does not aid the court's conclusion. On the contrary, it supports petitioner's argument that there is no realization of gain *at the time the improvements are added,* and that the realization of gain, if any,—and the taxation thereof as income—can only take place upon the sale or other disposition of the property.

The point is well stated in the majority opinion of the Circuit Court of Appeals, 2nd Circuit, in *Hewitt Realty Co. v. Commissioner,* 76 Fed. (2d) 880:

> "While the term lasts, the lessor receives nothing which benefits him but the rent; when it ends, he gets land for which he can get a higher rent—that is, if the building is neither outworn, nor outmoded. On all rents he must pay a tax. If he sells at any time, pending the term or after it ends, the building will increase his gain; and his taxes in proportion."

3. The decision of the court below ignores the practical difficulties and realities of the situation.

It seems fairly obvious that the regulations in question which tax as income to the lessor, either immediately or by spreading it over the term of the lease, the "estimated depreciated value" at the end of the lease of any improvements made by the lessee, are bound to be uncertain and difficult of application in particular cases.

These difficulties are set out so clearly in the dissenting opinion of a minority of the Board of Tax Appeals in

Morphy v. *Commissioner,* 35 B. T. A. 289, that the opinion is worth quoting:

"Arundell, dissenting: It seems to me that the decision of the Second Circuit in the *Hewitt Realty* case, 76 Fed. (2d) 880, gives a sound solution to the question here involved. The substance of the holding in that case is that the erection of a building by a lessee does not result in realization of income to the lessor; the realization of income, if any, occurs when the lessor sells. This view, as stated by Judge Learned Hand, author of the majority opinion, 'answers every fiscal necessity far more directly and simply than any other formula.'

"The lease in the instant case was for a period of over thirty years. Under the view expressed in the Commissioner's regulations and approved by the majority opinion, it is necessary to look into the future to the time when the lease terminates and determine the value of the building after taking into account the ravages of time. In many cases of long-term leases the original term extends beyond the useful life of the improvements. Some of them involve definite provisions for renewal. There are always the possibilities of termination prior to the expiration of the agreed term, and accelerated depreciation and obsolescence resulting from causes unforseeable when the lease is executed. These are factors that complicate any attempted application of the Commissioner's regulations. But what is more serious, they show the impossibility of determining with any fair certainty the amount to be treated under the regulations as realized income. A promise to turn over possession of a building many years hence, and subject to the many contingencies necessarily involved in any transaction extending over a period of years, does not seem to be in any proper sense the present equivalent of cash. Cf. *Burnet* v. *Logan,* 283 U. S. 404. The difficulty of determining as a matter of fact the value of improvements is recognized in both opinions filed in the *Hewitt* case. The majority opinion obviates the difficulty and offers a sound solution. It treats as income the full amount eventually realized when it is actually realized. Any-

thing short of this does not meet the test of realized income with which the taxing act is concerned. For these reasons, I think we should adopt the principle of the *Hewitt Realty* case and decline to follow the earlier cases that hold otherwise."

In the above cited case, *Morphy* v. *Commissioner,* 35 B. T. A. 289, and in *Sloan* v. *Commissioner,* 36 B. T. A. 370, the majority of the Board of Tax Appeals declined to follow the decision of the 2nd Circuit Court of Appeals in *Hewitt Realty Co.* v. *Commissioner,* 76 Fed. (2d) 880, and continued to uphold the regulations.

However, in a subsequent case, *Hart* v. *Commissioner,* 37 B. T. A. 360, which involved a lease containing a renewal option, the Board recognized the difficulty in applying the regulations to such cases and held that where the creation of one renewal term of the lease would put the date of the expiration of the lease beyond the depreciated life of the building, and where the option to renew did not involve any increase in rent due to the erection of the building, it cannot be said that the lessor realized any taxable income upon the making of the improvements, and that the questions when and whether taxable income is realized cannot be determined until the time when the lessee elects whether to renew or not.

The *Hart* case illustrates one of the situations where practical difficulties, as pointed out in the dissenting opinion in the *Morphy* case, will prevent the uniform application of the regulations as they stand.

The following paragraph from Paul & Mertens, *Law of Federal Income Taxation,* Vol. 1, sec. 10.12, 1937 Supplement, referring to the decision of the 2nd Circuit Court of Appeals in *Hewitt Realty Co.* v. *Commissioner,* may also be quoted:

> "This decision, if allowed to stand, will go far to remedy a situation full of at least potential injustice. The lessor has no realized income from the 'acquisition' of such buildings, in the sense of money from

> which a share may, without hardship, be devoted to the support of government. He has nothing with, or from which, to pay taxes. His income is in property which he cannot sell, and the majority opinion in its recognition of such practical considerations lays down the broad doctrine that in such cases the government should be content to wait for its taxes, as the taxpayer perforce must wait for his income, until there is a conversion into cash or its real equivalent."

In the instant case, it may also be noted that petitioner is a corporation subject to the tax on undistributed profits imposed by the Revenue Act of 1936, applicable to the years 1936 and 1937, and to some extent continued by the Revenue Act of 1938. The undistributed profits tax is a graduated tax, in effect a penalty tax, intended to force the distribution of corporate earnings or profits—that is to say, income. If the "income" which the Government has charged to petitioner here, not only for the taxable year actually involved in this case but likewise for every year of the lease in question, is in fact and in law income to petitioner as the Government contends, it becomes a problem to determine how it can be distributed so as to avoid the tax on undistributed profits.

II. When improvements are made by a lessee, as in the instant case, the accession of value to the property is not income but a capital addition.

As pointed out above, page 10, the lessee in the instant case was not required by the terms of the lease to spend any certain amount on improvements *for the benefit of the lessor.* All that the lessee agreed to do was to install proper fixtures and equipment for the operation of a theatre, which was the purpose for which he leased the property for a term of ten years. If the lessee made improvements so extensive that they would have a value beyond the term of the lease, as has been found, of course they would become the property of the landlord at the end of the term. To the ex-

tent of the value thereof at the end of the term, the improvements would appear to be a gift—or contribution to the landlord's capital.

Gifts have been expressly exempted in all the revenue acts beginning with the 1913 Act. Section 22 (b) (3) of the 1932 Act, which is the act here involved, provides:

> "(b) The following items shall not be included in gross income and shall be exempt from taxation under this title:
>
> * * *
>
> (3) Gifts, bequests, and devises.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);"

It follows that whatever increased value the lessor's property in this case may have, the added value is a capital addition and is not income.

On this ground, business subsidies have consistently been held not taxable as income to the recipient. The value of property conveyed to a company by business men or a chamber of commerce to induce it to locate its business on the property, is not taxable as income to the company. *Holton & Co.* v. *Commissioner*, 10 B. T. A. 1317. Similarly, where pursuant to contract, property was conveyed to a company when its pay-roll reached a certain amount. G. C. M. 16952, Cum. Bull. 1937-1, p. 133. Contributions to a railroad company for the construction of spur tracks or for other construction work are not taxable income. *Texas & Pacific Ry. Co.* v. *United States*, 72 Ct. Cls. 629, 52 Fed. (2d) 1040; affirmed on another issue, 286 U. S. 528. *Southern Ry. Co.* v. *Commissioner*, 27 B. T. A. 673; reviewed on other issues, 74 Fed. (2d) 887. *Baltimore & Ohio R. R. Co.* v. *Commissioner*, 30 B. T. A. 194.

Edwards v. *Cuba Railroad Co.*, 268 U. S. 628, involved the same question with respect to government subsidies. There the Cuba Railroad Company, a New Jersey corpora-

tion, was shown to have received from the Republic of Cuba from 1911 to 1916 large subsidies in cash, and certain land, buildings and equipment, all in aid of the construction of lines of railroad in Cuba. The Commissioner taxed the Company on the subsidy payments made in 1911 and 1912 under the Corporation Excise Tax Law of August 5, 1909, on the payments made in 1913, 1914 and 1915 under the Income Tax Law of October 3, 1913, and on the payments made in 1916 under the Revenue Act of 1916, as income. No attempt, however, was made to tax the land and other physical property turned over to the company. This court held that both the land and other physical property and the cash subsidies were equally contributions to capital and that the cash subsidies did not constitute income within the meaning of the Sixteenth Amendment, the opinion concluding as follows:

> "All—the physical properties and the money subsidies—were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income. Neither the laws nor the contracts indicate that the money subsidies were to be used for the payment of dividends, interest or anything else properly chargeable to or payable out of earnings or income. The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment."

Generally with respect to gifts, it may also be noted that under the earlier revenue acts, until 1921, the basis for determining the gain or loss to the donee upon a sale of donated property was its fair market value at the time of acquisition, *i. e.* the date of the gift. In 1921, to stop the practice of defeating, by means of a gift, the potential income tax on the sale of property having an appreciated value, Congress provided that the basis for determining gain or loss on the disposal of property acquired by gift after De-

cember 31, 1920, should be the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift. The validity of this original basis provision was upheld by this court in *Taft* v. *Bowers*, 278 U. S. 470, broadly on the ground that the statutory provision was a proper method for obtaining the income tax on the true appreciation in value of a capital asset after the date of realization.

Under the reasoning of *Taft* v. *Bowers*, it has been assumed that the gift itself could not be treated as taxable income when received by a donee, because income has not yet been realized by severance from capital, but that when the donee disposes of the donated property, so that a realization in the technical sense occurs, it is proper to determine to what extent the donated property represents transmitted capital and to what extent income. Roswell Magill, *Taxable Income*, pp. 358-367.

An analogy may also be found in the case of a bargain purchase of property, as for example where an employee of a corporation purchases stock of the corporation at less than its fair market value. The Commissioner has held, I. T. 3204, Int. Rev. Bulletin No. 29, July 18, 1938, that in such cases the employee receives additional compensation upon the acquisition of the stock to the extent of the difference between the amount he pays and the fair market value of the stock when issued to him. The Board of Tax Appeals and the courts, however, have not agreed with the Commissioner's theory of realization and have held that, unless there is clear evidence that the difference in value is intended as additional compensation, there is no realization of income upon the acquisition of the stock by the employee and that the gain, if any, is realized upon the sale or other disposition of the stock. *Geeseman* v. *Commissioner*, 38 B. T. A.—No. 37; *Omaha National Bank* v. *Commissioner*, 75 Fed. (2d) 434; *Rossheim* v. *Commissioner*, 92 Fed. (2d) 247.

III. The authorities cited in support of the conclusions reached by the court below are inapplicable.

The court below cites in support of its conclusions on the issue here involved, as quoted above, page 8, *Poe* v. *Seaborn*, 282 U. S. 101, *Lucas* v. *Earl*, 281 U. S. 111, and a number of cases in the several circuit courts of appeals.

The cases cited are obviously inapplicable. *Poe* v. *Seaborn* involved the question whether a husband and wife, residents of the State of Washington, where the community property system prevails, could split their joint income, including the husband's salary, and file separate returns, or whether the husband could be required to file one return and include therein all income. *Lucas* v. *Earl* involved an arrangement whereby a husband and wife contracted that all property which they might thereafter acquire in any way, either by earnings or otherwise, should be treated and considered as owned jointly, and the question was whether the husband's earnings thereafter were taxable to him. In each case the question was one of tax liability, as between two individuals, on what was admittedly income, not as to whether there was income. Here the question is more fundamental—whether there is in fact any income realized.

On the specific issue here involved, *Miller* v. *Gearin*, 258 Fed. 225, has already been mentioned, *supra*, page 5. *Miller* v. *Gearin* has been assumed to be authority for the proposition that a lessor may be taxed on the value of improvements added to real estate by the lessee thereof, as income realized by the lessor *at the time the improvements are added.* This assumption has been made by the Commissioner, by the Board of Tax Appeals, and by the court below in the instant case. The error in this respect and the misconception of the decision in *Miller* v. *Gearin* has been pointed out clearly in the opinions in the recent cases on the other side of this question, particularly in *Hewitt Realty Co.* v. *Commissioner*, 76 Fed. (2d) 880, *Hilgenberg* v. *United States*, 21 Fed. Supp. 453, and *Staples* v. *United States*, 21

Fed. Supp. 737. On this point in the *Hilgenberg* case the court said:

> "The theory underlying the present attitude of the Commissioner and all of the decisions of the Board of Tax Appeals appears to be founded on the misconception that since the value of the improvements is not income at the time the lease is terminated, it must of necessity be income when they are completed. This, of course, is a *non-sequitur*, because it need not be income at either time. * * * In so far as the decision in the *Miller* case, or in any other case referred to, is to be considered as a holding to this effect, we must disagree with such holding, because we believe that the conclusion, and the reasoning upon which such conclusion is based, in the *Hewitt Realty Company* case, *supra*, are more sound."

United States v. *Boston & Providence R. R. Corp.*, 37 Fed. (2d) 670, involved the question whether under the Revenue Act of 1918, which in the case of corporations required a determination of "invested capital" for the purpose of the excess profits tax thereby imposed, the earned surplus of a lessor railroad corporation should include the value of the obligation of its lessee to pay the principal and interest of the lessor's indebtedness. The particular facts were that the Boston & Providence R. R. Corporation, owner of a railroad between Boston and Providence, leased its road for ninety-nine years to the Old Colony R. R. Company, upon the undertaking of the latter to pay an annual rental of $900,000 a year, plus the expenses necessary to keep the corporate organization of the lessor alive, to pay all taxes and other assessments, to pay the lessor $1,300,000 in cash, and to create a sinking fund into which annual payments would be made by the lessee corporation sufficient to discharge, before the expiration of the lease, the funded and floating debt of the lessor, which amounted at that time to $2,170,000. The lessee also covenanted to apply the sinking fund in discharge of the lessor's indebtedness and to pay any deficiency. In 1893 the Old Colony assigned the

lease to the New York, New Haven & Hartford R. R. Company, which assumed the obligation in the lease to establish a sinking fund for the liquidation of the funded debt of the Boston & Providence. Until 1918 the lessor corporation had not carried on its books as an asset any item representing the obligation of its lessee to pay its funded debt. The question presented for decision was whether the lessor corporation's "invested capital" for 1918, for the purpose of the excess profits tax, should be increased by the cash value of the agreement of the lessee to pay its funded debt. The court held that it should be so increased, on the ground that the agreement to discharge the funded debt of the lessor should be treated as income received when the lease was originally made, and not having been distributed had become a part of the lessor's "undivided profits" or "earned surplus" and so a part of "invested capital" as defined in the statute. In reaching the conclusion stated, the court cited and relied on *Miller* v. *Gearin* as authority for the proposition that a building erected on leased land, under a covenant that it shall become and remain a part of the realty and the property of the lessor, is income to the lessor to the extent that it has enhanced the value of the lessor's property, and the fair market value thus added to the lessor's property is taxable to the lessor in the year in which the building is constructed.

In *Crane* v. *Commissioner*, 68 Fed. (2d) 640, the question was whether, where improvements were made by a lessee which were never reported as income by the lessor, the value of such improvements could be added to the basis for determining gain on the sale of the property by the lessor. The court held that the value of the improvements could not be so added to the basis, on the ground that under the regulations the value of the improvements should have been returned as income by the lessor at the time the improvements were completed, citing *Miller* v. *Gearin* and *United States* v. *Boston & Providence R. R. Corp.*, and that the statute and regulations "should not be construed to entitle

a taxpayer to the benefit of an expenditure made by his lessee, when the taxpayer has failed to report or to pay a tax in the proper year or years upon the income received by virtue of the lessee's expenditure.

In none of the cases cited, either *Miller* v. *Gearin* or *United States* v. *Boston & Providence R. R. Corp.* or *Crane* v. *Commissioner*, was the question here presented directly involved or fairly considered.

The court below (R. 13), and the Government in opposing certiorari in the instant case, also call attention to the fact that the position of the Treasury Department on the question here presented was taken as early as 1920 in the adoption of T. D. 3062 amending Article 48 of Regulations 45, and has presumably been approved by Congress as evidenced by the enactment of subsequent revenue acts without any reference to the regulations or rulings of the Treasury Department on this question.

The answer is obvious. No long continued administrative interpretation, or the enactment of subsequent revenue acts by Congress impliedly approving such administrative interpretation, can make income of that which is not income in the sense of the Sixteenth Amendment. *Koshland* v. *Helvering*, 298 U. S. 441. The constitutional question, whether there is income in the sense of the Sixteenth Amendment, must always be open.

But here, it may be said, the question is the construction of the statute, not its constitutionality, as stated at the beginning of this argument; *supra*, page 8. The Government made the same point, in effect, in *Towne* v. *Eisner*, 245 U. S. 418, moving to dismiss the writ of error for want of jurisdiction, on the ground that the only question involved was the construction of the statute, not its constitutionality. On this objection, the court by Justice Holmes said:

> "Whatever the meaning of the Constitution, the Government had applied its force to the plaintiff, on the assertion that the statute authorized it to do so, before the suit was brought, and the court below has

sanctioned its course. The plaintiff says that the
ute as it is construed and administered is uncons
tional. He is not to be defeated by the reply tha
Government does not adhere to the construction
virtue of which alone it has taken and keeps the pl
tiff's money, if this court should think that the
struction would make the act unconstitutional. W
it keeps the money it opens the question whether
act construed as it has construed it can be m
tained."

Respectfully submitted,

LAWRENCE CAKE,
Counsel for Petitioner.

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M. E. [illegible]

[illegible]

ON [illegible]

[illegible]

INDEX

CITATIONS

85979—38——1

Miscellaneous:

In the Supreme Court of the United States

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court below (R. 5–14) is reported in 23 F. Supp. 461.

JURISDICTION

The judgment of the Court of Claims was entered May 31, 1938 (R. 14). The petition for a writ of certiorari was filed June 7, 1938 (R. 14). The jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether the depreciated value of improvements to leased property made by a lessee as required by

the lease agreement constituted income to the lessor at the time of their completion.

STATUTE AND REGULATIONS INVOLVED

The pertinent portions of the applicable statute and Treasury regulations are set forth in the Appendix, *infra*, pp 15–16.

STATEMENT

The facts (R. 6–9) may be summarized as follows:

Petitioner, a corporation, made and filed a consolidated return of income for the taxable year ended January 31, 1932, for itself and a subsidiary corporation, the Mebco Realty Holding Company, (hereinafter referred to as the Realty Company), showing a tax due of $3,920.10, which was paid by petitioner (R. 6).

The Commissioner of Internal Revenue as a result of changes in the reported income of the Realty Company thereafter determined a deficiency in the tax amounting to $1,133.84, which was assessed against the petitioner and was paid by the petitioner September 5, 1934, with interest amounting to $160.41 (R. 6).

Among the changes so made which resulted in the deficiency was the addition to the income of the Realty Company of $1,742.31 as a result of the following transaction (R. 6–7):

On September 13, 1930, the Realty Company leased to the Ventnor Realty & Leasing Company

(herein referred to as the Ventnor Company) for use as a moving picture theater certain improved real estate owned by it in Atlantic City. The lease was for a term of ten years beginning upon the day certain improvements were completed by the landlord. With respect to the contemplated improvements the lease provided (R. 7):

> It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make and complete alterations to the entrance and theatre, which is to accommodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord.

On October 3, 1930, the Realty Company contracted for the making of alterations and improvements as contemplated by the parties to the lease, the contract providing that the Realty Company would pay the actual cost of the alterations and

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improvements provided that the total cost, including contractor's profit and architect's fee, should not exceed $65,000, and that any additional work and materials ordered by the Ventnor Company would be paid for by it (R. 7).

All the alterations and improvements were completed in January 1931, and the Ventnor Company, as lessee, took possession of the property February 1, 1931 (R. 8).

The total cost of all the alterations and improvements was $114,468.77, which was charged to the lessor and lessee, respectively, and paid for by them, as follows (R. 8):

Paid by the Realty Company, lessor:		
Brick, steel, lumber, concrete	$45, 068. 73	
Heating and plumbing system	7, 716. 82	
Electrical work	8, 699. 84	
Ventilation system (partial)	3, 514. 61	
		$65, 000. 00
Building changes	661. 86	
New store fronts (4)	8, 132. 61	
		8, 794. 47
		73, 794. 47
Paid by the Ventnor Company, lessee:		
Ventilating system (balance)	3, 950. 75	
Decorating, glazing, and architect's fee	11, 313. 14	
Chairs	9, 167. 24	
Booth	5, 197. 39	
Draperies	7, 075. 42	
Electric signs and marquee	3, 961. 36	
		40, 674. 30
		114, 468. 77

The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was computed by the

Commissioner and was agreed to by the petitioner, as follows (R. 8):

	Cost	Depreciated value at end of 10 years
Ventilating system	$3,959.75	$2,771.83
Glazing, architect's fee, and other items	10,366.37	7,256.46
Painting	760.80	0
Other improvements	185.97	0
Chairs	9,167.24	3,055.75
Booth	5,197.39	0
Draperies	7,075.42	2,358.47
Electric signs and marquee	3,961.36	1,980.63
	$40,674.30	$17,423.14

The Commissioner of Internal Revenue in accordance with Article 63 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, *infra*, p. 15, included in the lessor's income for the year in which the improvements were completed, one-tenth of their depreciated value, or $1,742.31.

The additional tax paid by the petitioner for 1932 as the result of this addition of $1,742.31 to the income of the Realty Company amounted to $211.61 (R. 8).

Petitioner thereafter filed a timely claim for refund on the ground that the addition of $1,742.31 to the income of the Realty Company was incorrect. This claim was disallowed February 5, 1937 (R. 9).

This suit was brought in the Court of Claims on July 12, 1937 (R. 1).

Upon the foregoing facts the Court of Claims decided that petitioner was not entitled to recover and dismissed the petition (R. 9), holding that the

depreciated value of the improvements made by a lessee under the circumstances involved in the instant case is income to the lessor in the year in which such improvements are completed.

ARGUMENT

We submit that the holding of the court below is correct. The value of the improvements constituted a part of the rent and as such is taxable under Section 22 (a), Revenue Act of 1932, *infra*, p. 15.

The obligation on the part of the lessee to make the improvements was an unconditioned requirement of the lease and the fact that such improvements would be made must necessarily have been treated as part of the consideration for making the lease.

Income does not have to be received in the form of cash to be taxable under the Revenue Acts. *United States* v. *Phellis,* 257 U. S. 156; *Rockefeller* v. *United States,* 257 U. S. 176. For example, if a lessee agrees under the terms of the lease to pay taxes due upon the leased property, the amount so paid by the lessee constitutes taxable income to the lessor. *Commissioner* v. *Terre Haute Elec. Co.,* 67 F. (2d) 697 (C. C. A. 7th), certiorari denied, 292 U. S. 624.

Petitioner makes no contention in this case that the depreciated value of these improvements could not be determined. Nor does the fact that the lessor's use of the improvements was deferred re-

lieve the income which they represent from taxation. It is not necessary that income be physically received to be taxable. As a result of the lease the lessor was deprived of the right to possession and beneficial use of the building and improvements until the end of the lease. But income is not divested of its character as such by an anticipatory arrangement which may limit its use or disposal by the taxpayer. *Lonsdale* v. *Commissioner,* 32 F. (2d) 537 (C. C. A. 8th), certiorari denied, 280 U. S. 575.

Under the circumstances of this case, where the improvements were clearly partial consideration for the lease, they were properly held to have constituted taxable gain to the lessor.

The holding of the court below is in accord with the long established administrative practice sustained by the preponderant authority of the decided cases.

The Treasury Regulations promulgated under the Revenue Acts of 1916 and 1918 provided that the depreciated value of improvements erected by a lessee constituted taxable income to the lessor upon the termination of the lease. Article 4, Par. 50, Regulations 33 (Rev. Ed.), and Article 48 of Regulations 45, respectively.

On May 5, 1919, in *Miller* v. *Gearin,* 258 Fed. 225, certiorari denied, 250 U. S. 667, the Circuit Court of Appeals for the Ninth Circuit decided that, assuming that the value of a building erected by a lessee

was income to the lessor, it was derived when the completed building was added to the real estate. The court stated (p. 226): "At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years." To the same effect is *Cryan* v. *Wardell*, 263 Fed. 248 (N. D. Cal.).

As a result of these two decisions, the Commissioner, in 1920, promulgated T. D. 3062, 3 Cumulative Bulletin 109, which amended Article 48 of Regulations 45, *supra*, to provide that the fair market value of improvements erected by a lessee constituted income to the lessor upon their erection.

Article 48 of Regulations 62, promulgated under the Revenue Act of 1921, permitted the lessor at his option either to report the income resulting from the construction of improvements as income for the year in which the improvements were completed to the extent of their fair market value, subject to the lease, or to return the estimated depreciated value of such improvements at the end of the lease as income in aliquot parts spread over the remaining life of the lease.

These same provisions with minor changes were incorporated in substance in Article 48 of Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively; Article 63 of Regulations 74, promulgated under the Revenue Act of 1928; Article 63 of Regulations 77, *infra*; Article 22 (a)–13 of Regulations 86 and 94, promul-

gated under the Revenue Acts of 1934 and 1936, respectively.

Thus, for eighteen years the Treasury Department has uniformly followed the practice of treating such improvements as income to the lessor.

During that time Congress has repeatedly reenacted the provision defining gross income without making in change in this respect. It is clear, therefore, that Congress has given approval to the administrative practice. *Brewster* v. *Gage,* 280 U. S. 327; *McCaughn* v. *Hershey Chocolate Co.,* 283 U. S. 488; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552; *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269.

The cases of *Miller* v. *Gearin* and *Cryan* v. *Wardell, supra,* have been interpreted by the Circuit Court of Appeals for the First Circuit in *United States* v. *Boston & Providence R. R. Corp.* 37 F. (2d) 670, and *Crane* v. *Commissioner,* 68 F. (2d) 640; and by the Board of Tax Appeals in *Scott* v. *Commissioner,* 9 B. T. A. 1219; *Alexander* v. *Commissioner,* 13 B. T. A. 1169; *Martin* v. *Commissioner,* 24 B. T. A. 813; *Murphy* v. *Commissioner,* 35 B. T. A. 289; and *Sloan* v. *Commissioner,* 36 B. T. A. 370, as authority for the proposition that the depreciated value of improvements on leased property is income to the lessor at the time the improvements are erected.

Petitioner contends that the decision of the court below is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880. In that case property was leased in 1929 for a term of twenty-one years with the contingent option to the lessee to renew for three successive like periods. The option to renew the lease was contingent upon the lessee erecting a new building upon the land, although, except as a condition of the option, the lessee was not required by the lease to erect the new building. In 1931 the lessee erected a new building on the land, and the Commissioner included in the taxable income of the lessor an amount which represented the 1931 portion of the depreciated value of such building as of May 1, 1950 (the date of the termination of the lease), computed on the basis of a 40-year life.

The majority opinion of the Second Circuit holds that this amount did not constitute income to the lessor in the year 1931, stating (p. 884):

> We concede that in a situation like that at bar a lessor need not receive money to be taxable; if improvements to land be portable—detachable machinery for example, which he can take off and sell as separate chattels—he receives income either when the lease is made, or when the term ends; for present purposes we need not say which. On the other hand, if the lease requires the les-

> see to drain the land, or set out shade trees, or pave it, or grade it, or build a golf course, or a race track on it, we can see no difference between the resulting increase in its value and that arising from the growth of the surrounding neighborhood, or the increase in value of a share of stock. The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.

The court in that case further holds that if a building so erected would be worthless when removed, it becomes income only when the land is sold. At the end of its opinion the court states also that another factor in reaching its conclusion was the fact that the lease was subject to renewal, which would make the depreciated value at termination of the lease difficult to determine in advance, since the date of such termination was uncertain.

The court below states that the *Hewitt* case is distinguishable upon the ground last mentioned—that the lease in the *Hewitt* case was subject to renewal—whereas the lease in this case was not renewable and the termination date was certain. While there is this factual distinction, and perhaps others, the majority opinion in the *Hewitt* case was not based primarily upon this circumstance, but

rather upon the character of the improvements constructed by the lessee, and the court held that the value of the buildings erected did not constitute income to the lessor until a sale or other disposition of the property occurred.

However, it also appears from the language quoted above from the opinion in the *Hewitt* case that the court there held that if improvements made by a lessee are portable and have value when removed from the land the depreciated value thereof constitutes income to the lessor, although the court leaves open the question of when such income accrues to the lessor. The improvements involved in this case are as follows (R. 8): Ventilating system; glazing, architects' fees, "and other items"; chairs; draperies; electric signs and marquee. It seems reasonably clear that the present case is not in conflict with the *Hewitt* case with respect to items such as chairs, draperies, and electric signs. Furthermore, in the absence of a finding that the marquee and ventilating system were not portable and would not have value if removed, no conflict has been definitely established with respect to these items. The same observation may be true as to the glazing. Although in all likelihood architects' fees would normally be incurred in connection with structural changes and would thus attach to the type of property held by the Second Circuit not to constitute income, even this does not appear con-

clusively, and the part of the lessee's total expenditure to be allocated to architects' fees is not disclosed.

CONCLUSION

The question whether the depreciated value of buildings erected by a lessee constitute income to the lessor at any time before the lessor disposes of the property is important from an administrative standpoint, and a clear difference of opinion exists with respect to it. Several District Court decisions cited in the petition have followed the *Hewitt* case, while the Board of Tax Appeals has held to the contrary in the decisions noted above in this Memorandum. Since the Court of Claims did not specifically limit its decision in this case to the particular types of property involved here, there may be a conflict between this case and the *Hewitt* case with respect to some of the items. Accordingly, the United States does not feel justified in opposing the petition unqualifiedly. However, it is deemed desirable to point out that because of the manner in which the improvements are itemized in this case and the indefiniteness of the record as to the exact character of the individual items, because the making of the improvements was an unconditional requirement of the lease here, and because it is not clear when the lessors' title to the improvements arose, the present case does not clearly present the question upon which a conflict

of opinion exists. Therefore we suggest that the present petition might appropriately be denied and the conflict in principle between the *Hewitt* case and this case resolved when the issue is more squarely presented.

Respectfully submitted.

N. A. Townsend,
Acting Solicitor General.
James W. Morris,
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Sewall Key,
Elizabeth B. Davis,
Special Assistants to the Attorney General.

August 1938.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

* * * * *

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INDEX

CITATIONS

100031—38——1

In the Supreme Court of the United States

OCTOBER TERM, 1938

No. 98

M. E. BLATT COMPANY, PETITIONER
v.
THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the court below (R. 5-14) is reported in 23 F. Supp. 461.

JURISDICTION

The judgment of the Court of Claims was entered May 31, 1938 (R. 14). The petition for a writ of certiorari was filed June 7, 1938 (R. 14), and was granted October 10, 1938. The jurisdiction of this Court is conferred by Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether the depreciated value of improvements to leased property made by a lessee as required by the lease agreement constituted income to the lessor at the time of their completion.

STATUTE AND OTHER AUTHORITIES INVOLVED

The pertinent portions of the applicable statute and other authorities involved are set forth in the Appendix, *infra*, pp. 22–34.

STATEMENT

Petitioner, a corporation, made and filed a consolidated return of income for the taxable year ended January 31, 1932, for itself and a subsidiary corporation, the Mebco Realty Holding Company (hereinafter referred to as the Realty Company), showing a tax due of $3,920.10, which was paid by petitioner (R. 6).

The Commissioner of Internal Revenue as a result of changes in the reported income of the Realty Company thereafter determined a deficiency in the tax amounting to $1,133.84, which was assessed against the petitioner and was paid by the petitioner September 5, 1934, with interest amounting to $160.41 (R. 6).

Among the changes so made which resulted in the deficiency was the addition to the income of the Realty Company of $1,742.31 as a result of the following transaction (R. 6–7):

On September 13, 1930, the Realty Company leased to the Ventnor Realty & Leasing Company (herein referred to as the Ventnor Company) for use as a moving picture theater certain improved real estate owned by it in Atlantic City. The lease was for a term of ten years beginning upon the day certain improvements were completed by the landlord. With respect to the contemplated improvements the lease provided (R. 7):

> It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make and complete alterations to the entrance and theatre, which is to accommodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord.

On October 3, 1930, the Realty Company contracted for the making of alterations and improve-

ments as contemplated by the parties to the lease, the contract providing that the Realty Company would pay the actual cost of the alterations and improvements, provided that the total cost, including contractor's profit and architect's fee, should not exceed $65,000, and that any additional work and materials ordered by the Ventnor Company would be paid for by it (R. 7).

All the alterations and improvements were completed in January 1931, and the Ventnor Company, as lessee, took possession of the property February 1, 1931 (R. 8).

The total cost of all the alterations and improvements was $114,468.77, which was charged to the lessor and lessee, respectively, and paid for by them, as follows (R. 8):

Paid by the Realty Company, lessor:		
Brick, steel, lumber, concrete	$45,068.73	
Heating and plumbing system	7,716.82	
Electrical work	8,699.84	
Ventilation system (partial)	3,514.61	
		$65,000.00
Building changes	661.86	
New store fronts (4)	8,132.61	
		8,794.47
		73,794.47
Paid by the Ventnor Company, lessee:		
Ventilating system (balance)	3,959.75	
Decorating, glazing, and architect's fee	11,313.14	
Chairs	9,167.24	
Booth	5,197.39	
Draperies	7,075.42	
Electric signs and marquee	3,961.36	
		40,674.30
		114,468.77

The estimated depreciated value at the termination of the lease of the alterations and improve-

ments paid for by the lessee was computed by the Commissioner and was agreed to by the petitioner, as follows (R. 8):

	Cost	Depreciated value at end of 10 years
Ventilating system	$3,950.75	$2,771.83
Glazing, architect's fee, and other items	10,306.87	7,256.46
Painting	760.80	0
Other improvements	185.97	0
Chairs	9,167.24	3,055.75
Booth	5,197.39	0
Draperies	7,075.42	2,358.47
Electric signs and marquee	3,961.36	1,980.68
	$40,674.30	$17,423.14

The Commissioner of Internal Revenue, in accordance with Article 63 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, *infra*, p. 25, included in the lessor's income for the taxable year ending January 31, 1932, one-tenth of their depreciated value, or $1,742.31 (R. 8).

The additional tax paid by the petitioner for 1932 as the result of this addition of $1,742.31 to the income of the Realty Company amounted to $211.61 (R. 8).

Petitioner thereafter filed a timely claim for refund on the ground that the addition of $1,742.31 to the income of the Realty Company was incorrect. This claim was disallowed February 5, 1937 (R. 9).

This suit was brought in the Court of Claims on July 12, 1937 (R. 1).

Upon the foregoing facts the Court of Claims decided that petitioner was not entitled to recover and dismissed the petition (R. 9), holding that the depreciated value of the improvements made by a lessee under the circumstances involved in the instant case is income to the lessor in the year in which such improvements are completed.

SUMMARY OF ARGUMENT

I

It is everywhere acknowledged that the construction of improvements by a lessee under the terms of the lease, where the improvements will outlast the lease's term, constitutes income to the lessor at some time. A divergence of views exists, however, as to the time when the improvements become income. With respect to this there are three different theories:

(a) *The view that the income is realized upon completion of the improvement.*—The legal significance of adding improvements to the lessor's property is precisely equivalent to the payment of advance rentals, and therefore the income is realized when the improvements are complete. The lessor is undoubtedly the owner as soon as the improvements are made, and if title be the test he has then derived income. The cash rentals are allocable in part to the improvements, so that the lessor has the immediate use of the improvement to that extent, just as he has the use and benefit of the rest

of the property. The only reason he is not entirely free to use the property is that he has agreed in advance with the lessee to permit the latter the exclusive use. This circumstance is analogous to the assigned income cases and should not prevent the tax. Moreover, the concept of income does not necessarily require that the respondent have the unrestricted right to enjoy it.

(b) *The view that the income is realized upon the termination of the lease.*—If the restrictions upon enjoyment prevent the income from being treated as derived when the improvements are made, it should follow that the income is received when the restrictions are removed. The principle is well recognized that the release of a liability is the equivalent of receipt, and where income is physically received at a time when there is some restriction upon its use, the time of receipt is deemed to be postponed until the restriction is removed. If that theory is applicable, the income is derived at the expiration or earlier termination of the lease.

(c) *The view that the income is realized upon disposition of the improved property.*—The theory that the income is realized upon the disposition of the property is based upon the view that the increased value which resulted from the improvements is merely appreciation of some character, like an increase resulting from fluctuating conditions. However, there is little similarity between

general conditions causing day-to-day fluctuations and a permanent improvement to the particular realty. Furthermore, this theory is based upon the misconception that there must be an actual physical separation of income from capital. We think the cases show that the concept of income is satisfied where the taxpayer's investment produces new property which, in some form, is made available to him. The simplicity of the theory has appealed to some courts, but if the income is lost as a result of unrelated events occurring between the time of its receipt and the disposition of the property, this theory would permit it to escape taxation altogether. In no other situation is a taxpayer excused from accounting for income because of its subsequent loss.

II

In this case the lease was for a ten-year term and it is agreed that certain of the improvements would outlast the term and that a residual value would remain for the lessor. Accordingly, the Commissioner added one-tenth of the residual value to the income of the lessor for the taxable year. This was in accordance with the Treasury Regulations, which proceed upon the theory that the income is realized when the improvements are complete. The case is squarely within the Regulations and the validity of the tax depends upon the acceptance of the theory which underlies the Regulations.

ARGUMENT

While this case presents the question whether the depreciated value of improvements to leased property, made by a lessee as required by the lease agreement, constitutes income to the lessor in the taxable year, the basic question is whether income is ever realized by the lessor in such cases, and, if so, when. In our memorandum in opposition to the petition it was suggested that the basic question is not presented in satisfactory form here and that a review by this Court might well await a case in which that issue is more clearly presented. We hope that the granting of the writ indicates that the Court is ready to deal with the broad question at this time. Accordingly, we shall not restrict the argument to the particular facts in this case but shall present our views upon the whole problem.

The question first arose under the Revenue Act of 1916. It has recurred from time to time under varying factual situations, but has never before reached this Court and no authoritative decision has been announced. The problem needs clarification and it would be desirable to have a decision which disposes of the basic questions.

I

IMPROVEMENTS MADE BY A LESSEE IN PURSUANCE OF AN AGREEMENT CONSTITUTE INCOME TO THE LESSOR

All of the tribunals which have considered this question have agreed that where the improvements

outlast the lease term the lessor derives income at some time and in some measure from improvements added to his real property by the lessee. However, there has been much diversity of opinion as to when the income is received and how it is to be measured. One line of authorities holds that the income is received when the improvements are made. Another line of cases holds that it is received when the lessor assumes possession of the property, at the end or earlier termination of the lease. A third group of authorities holds that income is not realized until the lessor disposes of the improved property. The first position stated above, adopted in the Treasury regulations and by the court below, we believe to be the correct one. However, we shall deal with these theories in turn and marshal the reasoning and authorities which may be urged in support of each.

(A) THE VIEW THAT INCOME IS REALIZED UPON THE COMPLETION OF THE IMPROVEMENTS

Improvements of the lessor's property, when made by a lessee pursuant to the lease, clearly constitute consideration paid for the use of the premises. Whether or not the cost may be deducted by the lessee (cf. *Duffy* v. *Central R. R.*, 268 U. S. 55), the lessor clearly appears in such cases to have received a consideration in the nature of rent. Improvements made by a lessee are of the same character and quality as a bonus paid by a lessee under an oil and gas lease. It is settled that the bonus is advance royalty. Like treatment of the im-

provements would require them to be classified as advance rentals. *Burnet* v. *Harmel,* 287 U. S. 103. The title to permanent improvements vests at once in the lessor and the value of the property is immediately increased. If title be the test (cf. *Poe* v. *Seaborn,* 282 U. S. 101), the lessor is undoubtedly the owner as soon as the improvements are made, and he has then derived income. Such was the view of the early cases. *Miller* v. *Gearin,* 258 Fed. 225 (C. C. A. 9th), certiorari denied, 250 U. S. 667; *Cryan* v. *Wardell,* 263 Fed. 248 (N. D. Cal.). The Regulations then in effect provided that the depreciated value of improvements erected by a lessee constituted taxable income to the lessor upon the termination of the lease.[1] But the cited cases overruled the existing regulations, whereupon the Treasury made changes to conform to the decisions.[2]

Against this view it may be urged that the lessor has not "derived" the income because he is not free to use it. But the lessor derives rent from the improvements and, to that extent at least, it would appear that he does use the improved property.

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[1] Article 4, par. 50, Regulations 33 (Revised Ed.); Article 48, Regulations 45.

[2] T. D. 3062, 3 Cumulative Bulletin 109; Mim. 2714, 4 Cumulative Bulletin 90; Article 48, Regulations 45 (1920 Ed.). The Regulations under the later Acts have consistently regarded the income as realized upon the completion of the improvements. The Regulations under the 1921 and subsequent Acts have permitted the gain to be spread over the life of the lease. Article 48, Regulations 62, 65, and 69; Article 63, Regulations 74 and 77; Article 22 (a)–13, Regulations 86 and 94.

The only reason he is not entirely free to use it is that he has agreed in advance that the lessee may have the exclusive right to use it for the term of the lease. In other situations it has been held that such an assignment does not avoid the tax. *Lucas* v. *Earl*, 281 U. S. 111; *Lonsdale* v. *Commissioner*, 32 F. (2d) 537 (C. C. A. 8th), certiorari denied, 280 U. S. 575. Cf. *Burnet* v. *Wells*, 289 U. S. 670.

Moreover, the concept of income does not necessarily require that the recipient have the exclusive right to enjoy it. The wife in a community property State clearly does not have any such exclusive enjoyment, but it is nevertheless settled that she is the recipient of one-half of her husband's income merely because under local law she is the owner of one-half. *Poe* v. *Seaborn*, *supra*. Analogous decisions indicate that income does not lose its character as such because prior to receipt it was dedicated to a particular use. *Cleveland Ry. Co.* v. *Lucas*, 36 F. (2d) 347 (C. C. A. 6th), certiorari denied, 281 U. S. 743. The constructive receipt cases also involve situations where the recipient has no opportunity to devote the income at will to any purpose desired. Thus the employee who receives income because his employer pays his tax is not free to devote such income to any purpose he desires. It can be used only to pay his tax. Nevertheless it is income. *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716. Likewise, the corporation which receives income when another cor-

poration pays its liabilities is not free to devote such income to any desired purpose. *United States* v. *Hendler,* 303 U. S. 564. See, also, *United States* v. *Boston & M. R. Co.,* 279 U. S. 732.

Since the tax is not computed upon the *value* of the improvements at the time they are made, it would appear that sufficient allowance has been made under this rule for the lessee's exclusive use during the term of the lease.

If this theory is sound, the decision below should be affirmed.

(B) THE VIEW THAT INCOME IS REALIZED UPON THE TERMINATION OF THE LEASE

Since improvements are usually made for the primary purpose of adapting the premises to the lessee's business requirements, it may be said that any benefit derived by the lessor at the time of construction is incidental. Cf. *Helvering* v. *Mountain Producers Corp.,* 303 U. S. 376, where it was held that a corporation which had the right to buy the oil produced at a price deemed to be favorable was conducting the operations for its own benefit. Furthermore, the lessee has the exclusive right to use the property during the term of the lease and the lessor's use is thus restricted. These circumstances have been relied upon to support the view that the income is not realized by the lessor until he actually comes into possession either at the expiration of the lease or upon its earlier termination.

This was the original view of the Treasury Department and the earliest Regulations were promulgated upon this theory.[8]

Further support for this view may be drawn from the cases which treat the release of a liability as the equivalent of receipt. *United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Helvering* v. *Amer. Chicle Co.*, 291 U. S. 426; and *Maryland Casualty Co.* v. *United States*, 251 U. S. 342. Those cases indicate that where income is physically received at a time when there is some restriction upon its use, the time of receipt is deemed to be postponed until the restriction is removed. The absence of restriction as to its disposition was one of the elements which this Court mentioned in *North American Oil* v. *Burnet*, 286 U. S. 417, 424, although it may make a difference whether the restriction is forced upon the taxpayer (cf. *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481) or is one which he assumes voluntarily.

If this be the correct theory, the entire gain can be taxed in a single subsequent year, when the lease terminates, instead of being prorated over the life of the lease.

(C) THE VIEW THAT INCOME IS REALIZED UPON THE DISPOSITION OF THE IMPROVED PROPERTY

The conclusion that the income is realized upon the disposition of the property was first announced

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[8] See note 1, p. 11.

in 1935. *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880 (C. C. A. 2d). It is based upon the theory that the increased value which results from improvements made to a particular property is merely appreciation of the same character as an increase in value resulting from the growth of the surrounding neighborhood or the increase in value of a share of stock. This was the prevailing view in the *Hewitt* case, Judge Chase dissenting.

This conclusion is predicated largely upon an interpretation of *Eisner* v. *Macomber*, 252 U. S. 189, as meaning that there must be an actual separation of income from capital. We think that this is too narrow a view. Subsequent to *Eisner* v. *Macomber*, this Court has held in *Marr* v. *United States*, 268 U. S. 536, 540, "that the gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property." See also *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 225. Thus in *Koshland* v. *Helvering*, 298 U. S. 441, the distribution of a different class of stock in the same enterprise supplied the "derivation" which was found wanting in *Eisner* v. *Macomber*. In each case the corporate funds continued to be held by the corporation so that it is apparent that an actual physical separation from capital need not be shown to establish the necessary "derivation." All that is necessary is that

the taxpayer's investment produce new property which in some form is made available to him.

The statement (p. 884) in the *Hewitt* opinion, that this theory "answers every fiscal necessity far more directly and simply than any other formula," is inaccurate. Under this theory no income whatever is deemed to flow from the lessee to the lessor; whether the lessor realizes income depends upon the price he gets from a purchaser instead of upon the value of the thing he receives from the lessee. Where the sale occurs some time after the lessor has come into possession of the improved property the selling price will be affected by later events which may have caused the increased value to disappear, leaving no profit whatever. Accordingly, the adoption of this theory will permit income from improvements to escape taxation entirely in many cases because of supervening factors wholly unrelated to the improvements. In other situations the loss of income after its receipt does not excuse the taxpayer from accounting for it. Therefore, whatever is to be said for the simplicity of this theory it clearly does not answer every fiscal necessity. Like the others, it must be judged upon its merits alone.

The *Hewitt* case involved other factors not present here and the opinion is at least partially based upon the fact that the lessee had an option to renew. The Court of Claims distinguished this case upon that ground.

If this theory must be applied, the tax should await the disposition of the property and will depend upon the selling price, except with respect to the portable improvements.[a]

II

THIS CASE IS SQUARELY WITHIN THE TREASURY REGULATIONS

In the instant case the lessor as a subsidiary corporation of the petitioner leased property to be used as a moving picture theatre. The lease was for a term of ten years and provided that the lessor should make certain alterations to the property and that the lessee should paint, decorate, and install the latest type of moving picture and talking apparatus, theatre seats, and furniture. It is agreed that certain of the improvements would last beyond the ten-year term, and there is no dispute as to the residual value. In this situation the Commissioner added one-tenth of the agreed residual value to the income of the lessor for the taxable year. This was in accordance with Article 63, Regulations 77 (Appendix, *infra*, p. 25), which proceeds on the theory that the lessor realizes the income when the improvements are complete. As shown above, this theory is consistent with the decision in *Miller* v. *Gearin*, 258 Fed. 225, *supra*, p. 11, and was adopted by the Treasury following the denial of certiorari in that case.

During the period from 1920 to 1935 the decisions in *Miller* v. *Gearin* and *Cryan* v. *Wardell*,

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[a] See *infra*, p. 20.

supra, were recognized as authority for the proposition that the improvements were taxable income upon their completion. They were so recognized by the Circuit Court of Appeals for the First Circuit in *United States* v. *Boston & Providence R. R. Corp.*, 37 F. (2d) 670, and *Crane* v. *Commissioner*, 68 F. (2d) 640; by the United States District Court for the Western District of Kentucky in the case of *Kentucky Block Coal Co.* v. *Lucas*, 4 F. Supp. 266; and by the Board of Tax Appeals in *Scott* v. *Commissioner*, 9 B. T. A. 1219, *Alexander* v. *Commissioner*, 13 B. T. A. 1169, and *Martin* v. *Commissioner*, 24 B. T. A. 813. In the decision by the District Court in *Kentucky Block Coal Co.* v. *Lucas*, *supra*, and in these three Board of Tax Appeals cases the question was the same as the one in issue here. They all held that the depreciated value of improvements erected by a lessee constituted income to the lessor at the time of their erection.

Since the decision of the Circuit Court of Appeals for the Second Circuit in *Hewitt Realty Co.* v. *Commissioner*, *supra*, in 1935, a number of District Court decisions have followed that case. These decisions are as follows: *Staples* v. *United States*, 21 F. Supp. 737 (E. D. Pa.); *Hilgenberg* v. *United States*, 21 F. Supp. 453 (Md.); *English* v. *Bitgood*, 21 F. Supp. 641 (Conn.); *Everett Dominick* v. *United States* (S. D. N. Y.), decided June 30, 1938, not yet officially reported but found in 1938 C. C. H., Vol. 4, p. 10300; *Lamont Dominick* v. *United States* (S. D. N. Y.), decided July 21,

1938, not yet officially reported but found in 1938 C. C. H., Vol. 4, p. 10406; *Fifteenth Street Inv. Co. v. Nicholas*, 23 F. Supp. 863 (Col.). On the other hand, the Board of Tax Appeals [4] and the United States District Court for the Territory of Hawaii [5] have declined to follow the decision in the *Hewitt Realty Co.* case and have reached the conclusion that the value of improvements erected under such circumstances constitutes taxable income to the lessor at the time of their erection.

Petitioner's contention that the lessee was not required to spend any amount whatever for the benefit of the lessor and that his expenditures might well have been limited to improvements which would have had a life not exceeding the term of the lease is not well taken. The lessee agreed to install "equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord" (R. 7). The lessee could not have fulfilled this obligation by installing flimsy equipment of an unsubstantial character. In all likelihood, had this been done, the lessor would have been the first to object. In fact it clearly was not contemplated

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[4] *Morphy* v. *Commissioner*, 35 B. T. A. 289; *Sloan* v. *Commissioner*, 36 B. T. A. 370.

[5] *Campbell* v. *United States* (T. H.), decided June 21, 1938, not yet officially reported but found in 1938 C. C. H., Vol. 4, p. 10283.

and was not done. Moreover, the installation of inferior material would have defeated the lessee's own purpose to attract the public to its theatre. Judge Chase's dissenting opinion in the *Hewitt Realty Co.* case, *supra*, reasons that the character of what the lessor receives remains the same even though the lessee is not obligated to make the improvements. Here the petitioner was clearly required to make improvements which would be substantial and leave a residual value for the lessor and actually made such improvements. The improvements are listed in the statement of facts. Some of them clearly would be classed as portable and thus satisfy the requirements of income even if the prevailing *Hewitt Realty Co.* opinion is applicable.

Petitioner's suggestion that the lessee made a gift of the improvements is unsound and the cases dealing with business subsidies (Br. 17) are clearly distinguishable because here the improvements were obviously not made without consideration. Unlike this case, no landlord-tenant relationship or any other contractual relationship existed in the cited cases. We submit that no payment directly attributable to such a relationship could be a gift or subsidy. The latter distinction applies also to the cases cited (Br. 19) dealing with bargain purchases by employees. Unless the intention to pay additional compensation appears, the transaction is not necessarily connected with an employer-employee rela-

tionship, but where it does appear that the difference in value is intended to compensate for services, that difference is clearly income because it is due wholly to the employer-employee relationship. Cf. *Bogardus* v. *Commissioner*, 302 U. S. 34, 41.

CONCLUSION

The value of improvements erected by a lessee upon leased land constituted income to the lessor. The soundest theory seems to be that such income is taxable at the time the improvements are erected.

The decision of the court below is correct and should be sustained.

Respectfully submitted.

ROBERT H. JACKSON,
Solicitor General.

JAMES W. MORRIS,
Assistant Attorney General.

J. LOUIS MONARCH,
ELIZABETH B. DAVIS,
Special Assistants to the Attorney General.

NOVEMBER 1938.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after the date of the enactment of this Act, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

* * * * *

Treasury Regulations 33, promulgated under the Revenue Acts of 1916 and 1917:

ART. 4. * * * *Permanent improvements under lease or rental contracts.*—When improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation dur-

ing the lease term is gain or profit to the lessor at the end of the lease term and is to be accounted for as income at that time. (T. D. 2442.)

Treasury Regulations 45, promulgated under the Revenue Act of 1918 (1920 Ed.):

ART. 48. *Improvements by lessees.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of

the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. See articles 109 and 164.

Treasury Regulations 62, promulgated under the Revenue Act of 1921 (1922 Ed.):

ART. 48. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each year of the lease an aliquot part thereof.

If for any other reason than a bona fide purchase from the lessee by the lessor the lease is terminated, so that the lessor comes into possession or control of the property

prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on the cost or the value subject to the lease as of that date, whichever is lower, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. See articles 109 and 164.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

Except in cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives no income by reason thereof, and, just as when the lessor comes into possession or control of the property upon the expiration of the lease, the basis for determining gain or loss to the lessor from the subsequent sale or other disposition of the buildings or improvements and for depreciation in respect of such property is the amount previously reported as income by the lessor because of the erection of the buildings or improvements, except that if the buildings or improvements were acquired prior to March 1, 1913, the basis shall be their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or

improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on their value subject to the lease when acquired or their value subject to the lease on March 1, 1913, whichever is greater, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise. (See articles 130 and 204.)

In all cases where the lessor has exercised the option to report income upon basis (b), if the lease is terminated so that the lessor comes into possession or control of the property prior to the time originally fixed for the expiration of the lease, the lessor derives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he becomes entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the termination of the lease shall be included. If the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss is not compensated for by insurance or otherwise.

Treasury Decision 3062, 3 Cumulative Bulletin 109:

SECTION 213 (a), ARTICLE 48: 37-20-1198
Rents and royalties. T. D. 3062

INCOME TO LESSORS OF IMPROVEMENTS MADE UPON REAL ESTATE BY LESSEES—ARTICLES 48, 109, AND 164 OF REGULATIONS 45, AMENDED

Articles 48, 109, and 164 of Regulations 45 are hereby amended to read as follows:

ART. 48. *Rents and royalties.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same com-

pleted became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. (See articles 109, 164.)

* * * * *

Mimeographed Decision 2714, 4 Cumulative Bulletin 90:

SECTION 213 (a), ARTICLE 48: Improvements by lessees. 8-21-1474
Mim. 2714

(Also Section 214 (a) 1, Article 109.)
(Also Section 214 (a) 8, Article 164.)

INCOME TO LESSOR FROM IMPROVEMENTS ERECTED BY THE LESSEE UPON LEASED GROUND

Treasury Decision 3062 (C. B. 3, pp. 109, 144, 171), dated September 1, 1920, dealing with the question of the realization of income by a lessor from the erection by the lessee of improvements on leased ground, has been the subject of many inquiries. It is deemed advisable, therefore, to state the reasons for its promulgation and to demonstrate the proper construction of it by application to a specific case.

On February 6, 1917, by Treasury Decision 2442 (not in bulletin service), the Bureau held that where, under the terms of a rental or lease contract, a tenant agrees to erect a building or other permanent improvement upon the freehold of another, the building or improvements become a part of the realty, and the difference between the cost of the improvements and the allowable depreciation during the lease term is gain or profit to the lessor at the end of the lease term and is to be accounted for as income at that time.

The ruling contained in Treasury Decision 2442 was adhered to by the Bureau and was embodied, with some minor changes, in Regulations 33, revised, article 4, paragraph 50, and in Regulations 45, article 48. The Bureau abandoned this ruling only when forced to do so by the courts. In the case of *Miller* v. *Gearin*, 258 Fed. 225, the Circuit Court of Appeals for the Ninth Circuit held that the value of improvements erected upon leased ground by a lessee is not income to the lessor *at the expiration of the term of the lease.* A writ of certiorari was sought from the Supreme Court but was denied. Following this decision came the case of *Cryan* v. *Wardell*, 263 Fed. 248, reaching the same conclusion. In both of these decisions it is held that the value of improvements erected on leased ground by a lessee is not income of the lessor at the termination of the period of the lease, and it is stated, obiter dictum, that the income, if any, is realized when the buildings or improvements are erected and title passes to the lessor. In *Miller* v. *Gearin, supra,* the court said:

"The lessor acquired nothing in 1916 (the year of the termination of the lease) save the possession of that which for many years

had been her own. It was not a gain but a loss. Assuming that the building was income derived from the use of the property we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value."

And in *Cryan* v. *Wardell*, supra, it is stated:

"The right to levy the tax turns upon the question: When did title to this building vest in plaintiff and become a part of her property for the purpose of taxation? I am of opinion that under well-settled principles, aptly expressed in section 1013, Civil Code of California, the moment the building was erected, which the terms of the lease show was to become and remain an integral portion of the land upon which it was constructed, the title thereto vested as completely in plaintiff as though constructed by the plaintiff herself, * * *. It, therefore, became, upon the completion, a part and parcel of plaintiff's income-bearing property, and was subject to taxation in her as of that date."

As a result of these decisions, the office modified its prior rulings on the subject, and T. D. 3062 was accordingly promulgated.

The adoption in T. D. 3062 of the view occasioned by the above cited decisions, that the value of improvements erected on leased ground by the lessee is income to the lessor upon the passage of title, raised the further question as to the measure of the income to be returned by the lessor.

Although the lessor has acquired title to the improvements upon their erection by the lessee, yet it is obvious that the lessor has not received their full value, as measured by

an unrestricted dominion over them, inasmuch as his proprietorship is subject to the exclusive right of the lessee to their possession and use during the term of the lease. In recognition of this point it is held in T. D. 3062, that the lessor must include in gross income for the year in which title passes the depreciated value of the improvements—that is, he includes in gross income the estimated present value to him of the improvements, the possession and enjoyment of which is postponed until the termination of the period of the lease. To compute this depreciated value, the value of the land free from the lease without the improvements is subtracted from the value of the land subject to the lease and with the improvements. Inasmuch as the lessor has included in income only the depreciated value of the improvements, in effect taking his depreciation deductions in advance, he is entitled to no depreciation deduction with respect to such improvements until the expiration of the term of the lease when he gains the possession.

The following example is given to illustrate the proper construction to be given to T. D. 3062:

A, in 1915, leases certain land to B for 20 years. B agrees, in part consideration for the lease, to erect on the leased ground a building, specifications agreed upon, of an estimated life of 25 years and to cost $50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of 25

years and cost of $50,000, the use and enjoyment of which is postponed for 15 years. The depreciated value of the building at the termination of the period of the lease will be approximately $20,000—that is, cost less depreciation sustained. The income of A, then, is the discounted value of $20,000 receivable at the end of 15 years. If market value reflects intrinsic value, this amount should equal the difference between the value of the land free from the lease without the buildings and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the taxpayer of the legal title to the encumbered building. Since A has included in income only the depreciated value of the building, he is entitled to a depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a "cost" value equal to the market value placed on the encumbered building by A in the year of its erection, i. e., the annual depreciation deduction for 1935 and subsequent years will be the quotient obtained by dividing (a) the value of the improvements to A as determined by him when the same completed became part of the realty, by (b) the number of years in the estimated remaining life of the improvements from the termination of the lease.

In any case in which the term of the lease is greater than the estimated life of the improvement no income should be accounted

for by the lessor at the time of the passage of title. Also if the improvements will have no value at the termination of the lease, as is often the case in mining leases, no income is realized by the lessor.

U. S. GOVERNMENT PRINTING OFFICE: 1938

SUPREME COURT OF THE UNITED STATES.

No. 98.—October Term, 1938.

M. E. Blatt Company, Petitioner, vs. United States. } On Writ of Certiorari to the Court of Claims.

[December 5, 1938.]

Mr. Justice Butler delivered the opinion of the Court.

Petitioner paid, and in this suit seeks to recover, an amount included in a deficiency assessment made by the Commissioner of Internal Revenue as additional income tax for the year ending January 31, 1932. The question is whether petitioner is liable under Revenue Act of 1932, § 22(a).[1]

The material substance of the findings follows.

For itself and a subsidiary corporation, petitioner made consolidated return. The commissioner added to the income of the subsidiary on account of improvements made to its property by a lessee. He ruled the improvements were income to lessor in that year to the extent of their value at termination of the lease.

Lessor purchased the real estate in 1927, and September 13, 1930, leased it for use as a moving picture theater for a term of ten years, beginning upon completion of improvements to be made. At its own cost and expense, lessor agreed to make alterations in accordance with plans and specifications prepared by an architect selected by the parties. Lessee agreed to install the latest type of moving picture and talking apparatus, theater seats and all other fixtures, furniture and equipment necessary for the successful operation of a modern theater to become the property of lessor at the expiration or sooner termination of the lease.

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1 "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ." 47 Stat. 178. The regulation applied by the commissioner (Reg. 77, Art. 63) has since been changed. See Reg. 94 and 86, Art. 22(a)-13.

Lessor made a contract with the builder to make the contemplated improvements and agreed to pay, up to a specified limit, actual cost, plus builder's profit and architect's fee. Additional work ordered by lessee was to be paid for by it. Lessee consented to the terms of the contract and agreed to pay for work and materials ordered by it. All improvements were completed in January 1931; lessee took possession of the property February 1 of that year.

The total cost of all improvements was $114,468.77; lessor paid $73,794.47; lessee paid the balance, $40,674.30. "The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was computed by the commissioner and was agreed to by the plaintiff [petitioner], as follows:

	Cost	Depreciated value at end of 10 years
[1] Ventilating system	$3,959.75	$2,771.83
[2] Glazing, architect's fee and other items	10,366.37	7,256.46
[3] Painting	760.80	0
[4] Other improvements	185.97	0
[5] Chairs	9,167.24	3,055.75
[6] Booth	5,197.39	0
[7] Draperies	7,075.42	2,358.47
[8] Elec. signs and marquee	3,961.36	1,980.63
TOTAL....................	$40,674.30	$17,423.14"

From these figures it appears that the calculations were based on annual depreciation of items [1] and [2] at 3 per cent., on [5] and [7], at 6⅔ per cent., on [8], at 5 per cent., and on [3], [4], and [6], at 10 per cent."

For the year in question, the commissioner added to income of lessor $1,742.31, one-tenth of the cost so depreciated. The resulting additional tax was $211.61. Petitioner paid it; the commissioner disallowed claim for refund. The lower court held petitioner not entitled to recover; it sustained the tax on the ground that, immediately upon completion of the improvements made by lessee, they became the property of lessor, and constituted compensation paid by lessee as additional rental for the use of the leased premises.

Petitioner insists that where improvements are made by lessee, there is no realization of gain at the time the improvements are

mpleted; that the accession of value to the property is not income t a capital addition. The United States says that, while the se presents the question whether depreciated value of improvements by lessee constitutes income to lessor in the taxable year, he "basic question is whether income is ever realized by the lessor such cases, and if so, when." Assuming that improvements ade by lessee and which will outlast the term constitute income lessor at some time, its brief discusses the questions whether he income is realized upon (1) completion of the improvements, 2) termination of the lease, or (3) disposition of the improved roperty. It concludes that the "soundest theory seems to be that uch income is taxable at the time the improvements are erected." And, without supporting the lower court's ruling that the estimated depreciated value at the end of the ten-year term constituted additional rent or compensation paid for the use of the premises, it asks that the judgment be upheld.

We are not called on to decide whether under any lease or in any circumstances, income is received by lessor by reason of improvements made by lessee, nor to choose, for general approval or condemnation, any of the theories expounded by the United States. Concretely, the question presented is whether, under the lease here involved, one-tenth of what the commissioner and taxpayer call and agree to be "estimated depreciated value," as of the end of the term, was income to petitioner in the first year of the term. And that question is to be decided upon the lower court's special findings unaffected by any statement of fact, reasoning, or conclusion that may be found in its opinion.[2]

There is nothing in the findings to suggest that cost of any improvement made by lessee was rent or an expenditure not properly to be attributed to its capital or maintenance account as distinguished from operating expense. While the lease required it to make improvements necessary for successful operation, no item was specified, nor the time or amount of any expenditure. The requirement was one making for success of the business to be done on the leased premises. It well may have been deemed by lessor essential or appropriate to secure payment of the rent stipulated in the lease. Even when required, improvements by lessee will

[2] Stone v. United States, 164 U. S. 380, 383. Crocker v. United States, 240 U. S. 74, 78. Brothers v. United States, 250 U. S. 88, 93. United States v. Wells, 283 U. S. 102, 120. United States v. Esnault-Pelterie, 299 U. S. 201, 206. And see American Propeller Co. v. United States, 300 U. S. 475, 479-480.

not be deemed rent unless intention that they shall be is plainly disclosed. Rent is "a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property . . . . . . it does not include payments, uncertain both as to amount and time, made for the cost of improvements . . . ."[3] The facts found are clearly not sufficient to sustain the lower court's holding to the effect that the making of improvements by lessee was payment of rent.

It remains to be considered whether the amount in question represented taxable income, other than rent, in the first year of the term.

The findings fail to disclose any basis of value on which to lay an income tax or the time of realization of taxable gain, if any there was. The figures made by the commissioner are not defined. The findings do not show whether they are intended to represent value of improvements if removed or the amount attributable to them as a part of the building.

The figures themselves repel the suggestion that they were intended to represent amounts obtainable for the items if removed. We are not required to assume that the commissioner intended his estimates to represent salvage, at the end of the term, of ventilating system, glazing, architect's fees and the like, draperies, chairs, electric signs, and marquee, the useful lives of which in place have declined from 30 to 66⅔ per cent. It does not appear that if detached from the building they would then have any value, even as junk, over necessary cost of removal. It is clear that, if any value as of that time may be attributed to them, it is included in and not separable from that of the leased premises.

Equally conjectural would be assumption that the figures represent enhancement of value of the leased premises by reason of the improvements when new or as deteriorated at the end of the term. The leased property is capable of inventory and analysis for the purpose of ascertaining original and estimated present costs of its elements and other relevant facts as indications of worth to be taken into account in determining its value; i.e., the money equivalent of the property as a whole.[4] But present or

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[3] Duffy v. Central R. R., 268 U. S. 55, 63. Dodge v. Hogan, 19 R. I. 4, 11. Guild v. Sampson, 232 Mass. 509, 513. Garner v. Hannah, 6 Duer 262, 266. Board of Comm'rs of Caddo Levee Dist. v. Pure Oil Co., 167 La. 801, 811. 2 Blackstone, p. 41.

[4] West v. C. & P. Tel. Co., 295 U. S. 662, 671. Olson v. United States, 292 U. S. 246, 255. Standard Oil Co. v. So. Pacific Co., 268 U. S. 146, 155.

re value, however ascertained, is single in substance; it can- be arrived at by mere summation of actual or estimated cost nstituent elements, new or depreciated.[5] The addition to e of the leased premises resulting from the lessee's improve- nts may not be arrived at by formula or arithmetically by merely ting against each item or element its cost less depreciation esti- ted to accrue during the term of the lease.[6] The amount in- ded in the total value of the structure reasonably to be attributed the improvements after use for ten years is not ascertainable by e simple calculations employed by the commissioner.

Granting that the improvements increased the value of the build- g, that enhancement is not realized income of lessor.[7] So far as cerns taxable income, the value of the improvements is not dis- guishable from excess, if any there may be, of value over cost f improvements made by lessor. Each was an addition to capital; t income within the meaning of the statute.[8] Treasury Regula- ns can add nothing to income as defined by Congress.[9]

But, assuming that at some time value of the improvements would e income of lessor, it cannot be reasonably assigned to the year which they were installed. The commissioner found that at the d of the term some would be worthless and excluded them. He o excluded depreciation of other items. These exclusions imply hat elements which will not outlast lessee's right to use are not t any time income of lessor. The inclusion of the remaining value s to hold that petitioner's right to have them as a part of the uilding at expiration of lease constitutes income in the first year f the term in an amount equal to their estimated value at the end f the term without any deduction to obtain present worth as of date f installation. It may be assumed that, subject to the lease, lessor

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[5] Denver Stock Yard Co. v. United States, 304 U. S. 470, 479.

[6] Minnesota Rate Cases, 230 U. S. 352, 434. Bluefield Co. v. Pub. Serv. Comm., 262 U. S. 679, 690. Standard Oil Co. v. So. Pacific Co., 268 U. S. 146, 57, 159. McCardle v. Indianapolis Co., 272 U. S. 400, 416.

[7] Hewitt Realty Co. v. Commissioner (CCA 2), 76 F. 2d 880, 884. Eisner v. Macomber, 252 U. S. 189, 207. Lucas v. Alexander, 279 U. S. 573, 577. Cf. Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, 175.

[8] United States v. Phellis, 257 U. S. 156, 169, 175. Merchants' L. & T. Co. v. Smietanka, 255 U. S. 509, 519-520. Taft v. Bowers, 278 U. S. 470, 480, et seq. Lucas v. American Code Co., 280 U. S. 445, 449. Eckert v. Burnet, 283 U. S. 138, 142. Burnet v. Logan, 283 U. S. 404, 412-413. United States v. Safety Car Heating Co., 297 U. S. 88, 99. Koshland v. Helvering, 298 U. S. 441, 444-445. Cf. Commissioner v. Van Vorst (CCA 9), 59 F. 2d 677, 680.

[9] Koshland v. Helvering, 298 U. S. 441, 447.

became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

PREME COURT OF THE UNITED STATES.

No. 98.—October Term, 1938.

E. Blatt Company, Petitioner, *vs.* United States. } On Writ of Certiorari to the Court of Claims.

[December 5, 1938.]

Mr. Justice Stone.

acquiesce in that part of the Court's opinion which construes findings below as failing to establish that the lessees' improve-ts resulted in an increase in market value of the lessor's land he taxable year. As it is unnecessary to decide whether such ease, if established, would constitute taxable income of the or, I do not join in so much of the opinion as, upon an as-ption contrary to the findings, undertakes to discuss that stion.